

# WHAT DOES KENTUCKY VALUE?



A PREVIEW OF  
THE 2020-2022  
BUDGET OF THE  
COMMONWEALTH

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By Kentucky Center for Economic Policy  
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ABOUT US

The Kentucky Center for Economic Policy is a non-profit, non-partisan initiative that conducts research, analysis and education on important policy issues facing the commonwealth. Launched in 2011, KCEP is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP's website [www.kypolicy.org](http://www.kypolicy.org).



# WHAT DOES KENTUCKY VALUE?

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### EXECUTIVE SUMMARY

**K**entucky's state budget is the primary policy document of the commonwealth, establishing how the state lives out shared values. Through investments ranging from schools to infrastructure to health, the budget helps create the conditions in which Kentuckians either prosper together or struggle to access opportunity. Strong investments can give children a bright start, set the stage for a thriving economy, promote racial equity, reduce economic inequality, make Kentuckians healthier and happier and bridge gaps between rural and urban communities. The budget reflects priorities.

Yet Kentucky has been disinvesting in most areas of the budget for over a decade now. While many states have come out of the Great Recession and begun restoring the fundamental building blocks of a strong economy, Kentucky continues to cut. The most recent budget enacted in 2018 reduced funding another 6.25% in many crucial areas, and small increases in some agencies' budgets barely staved off full-blown crises. Rising costs in the next biennium—including those due to harmfully high rates of incarceration, changes to pension assumptions and due to inflation—will leave little to none of the anticipated revenue growth to fill deep budget holes in human services, education, mental health and many other areas that have widened over the years. And while funding pensions at the actuarially required amount in the last two budget cycles has put these systems on better footing, sustainable new revenue is needed in order to alleviate pressure on other important budgetary priorities.

This report explores the issues facing the Governor and General Assembly as they craft the new 2020-2022 Budget of the Commonwealth—from both sides of the ledger. On the appropriations side, lack of funding increases is allowing inflation to erode core formula funding for schools, while other education funding streams like textbooks and Extended School Services have been deeply cut or completely eliminated. The average net cost to attend the state's public universities has increased 40% since 2008 driven by repeated cuts in state funding for higher education. And Kentucky faces crises and underfunding problems in many areas of health and human services, including social workers handling nearly double the recommended caseloads.

On the resources side, weak revenue growth is anticipated over the biennium. The state faces long-term erosion due to a tax code filled with exemptions and breaks for special interests. New tax cuts for wealthy Kentuckians and corporations in the 2018 and 2019 legislative sessions negatively affect revenue collections in the biennium and going forward.

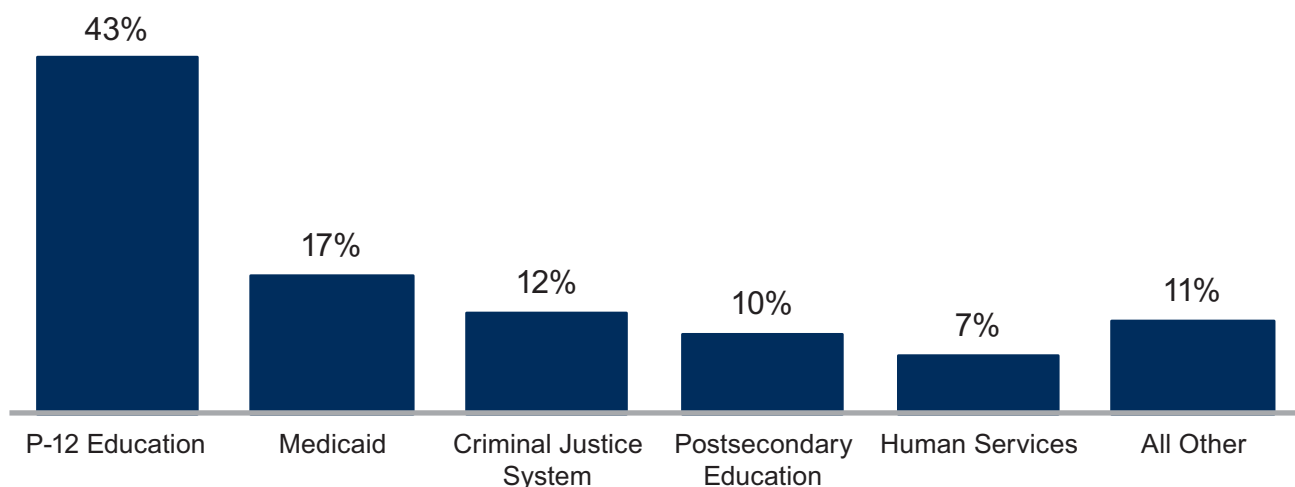
The experience of states like Kansas and North Carolina shows that giving tax breaks to those at the top is not an effective strategy for states to improve their economies. Putting Kentucky's budget back on the path of shared values will require that legislators begin cleaning up the tax code to generate new revenue, or see another two-year budget in which disinvestment continues.

## PART I: THE BUDGET

The chart below illustrates the major ways the state's General Fund, which totals over \$11 billion a year, is spent. Part I of the report provides an overview of state spending, gives examples of the compounding impact of a decade or more of cuts and describes costs the state is facing in the next budget.

### State Budget Funds a Broad Array of Vital Public Services

Categories of state-funded public services as share of General Fund appropriations



Source: Commonwealth of Kentucky 2018–2020 Budget of the Commonwealth: Budget in Brief.

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## EROSION OF P-12 SCHOOL FUNDING CONTINUES

Kentucky schools continue to struggle with fewer resources due to funding cuts in recent years that have had a significant negative impact on kids and classrooms. Investments in education are critical to the state's health and economic well-being, but Kentucky continues to lag behind other states, receiving an "F" in Education Week's 2019 Quality Counts report for education spending.<sup>1</sup> According to a recent report by the Center on Budget and Policy Priorities, in 2019, school "formula funding" in Kentucky (the SEEK formula or "Support Education Excellence in Kentucky") ranked 4th worst among states for per-student funding cuts—a 13% drop since 2008 in inflation-adjusted terms.<sup>2</sup>

### PER-STUDENT FUNDING HAS BEEN CUT

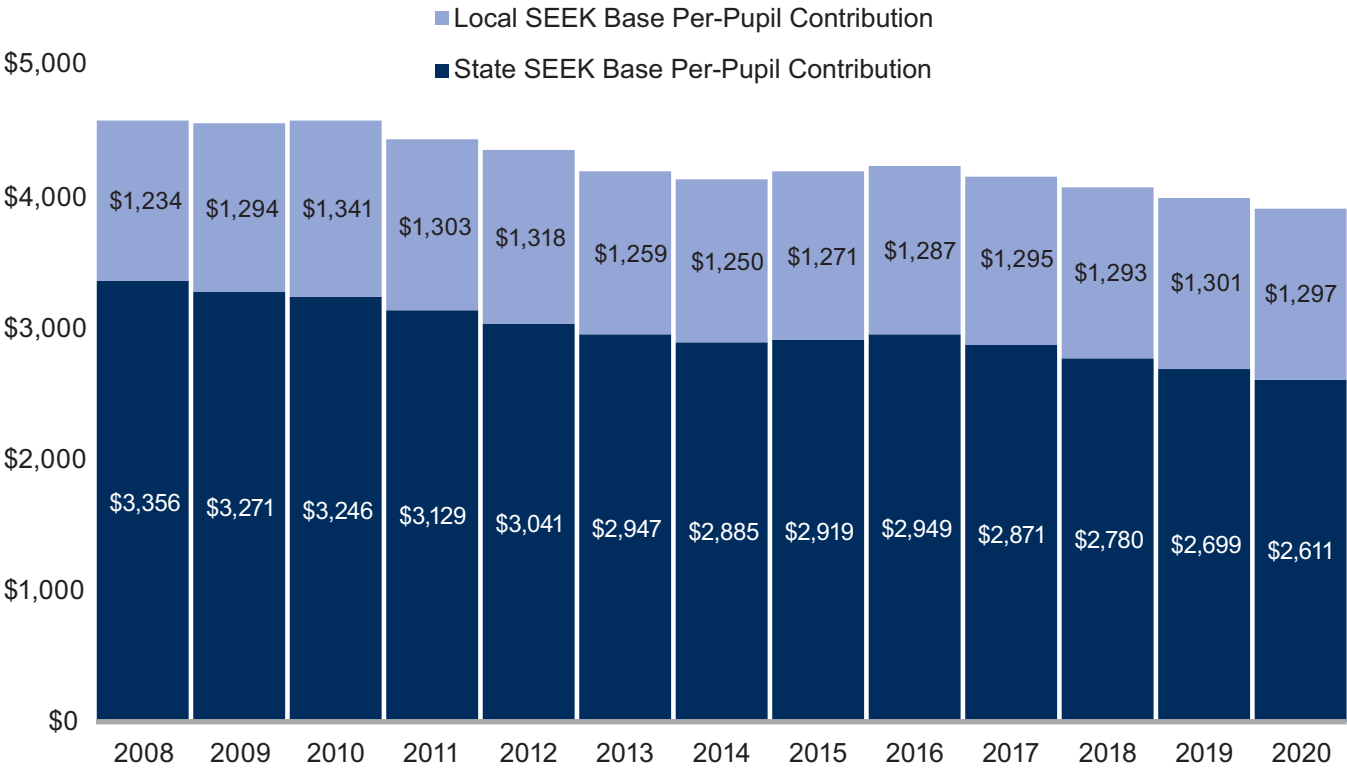
The largest component of education funding is the SEEK formula, which provides state funding to school districts based on wealth and local effort. SEEK includes what is called a "base guarantee" of funding for every student that is established in the budget. The base guarantee is \$4,000 for both years in the current budget (up from

\$3,822 in 2008). It is funded through a combination of state and local funds, with the state contributing more to districts that have less property wealth, and therefore less ability to raise revenues locally. Some have described Kentucky’s current state education funding levels as “historically high,” pointing to the \$4,000 base guarantee which, in nominal terms, is an increase. A closer looks shows that does not mean a record state commitment to funding SEEK.

Since the base guarantee is made up of both state and local funds, it is important to understand how that responsibility is shared. The state portion declined on a per-pupil basis by \$122 between 2008 and 2020, while the local portion grew by \$300.<sup>3</sup> Thus, the cost of the nominal increase in base funding is being borne primarily by local school districts. In addition, these numbers do not account for inflation. When inflation is factored in, as shown in the graph below, the per-pupil guarantee is lower in 2020 than it was in 2008 by \$682 per student, a decline of 22%.<sup>4</sup>

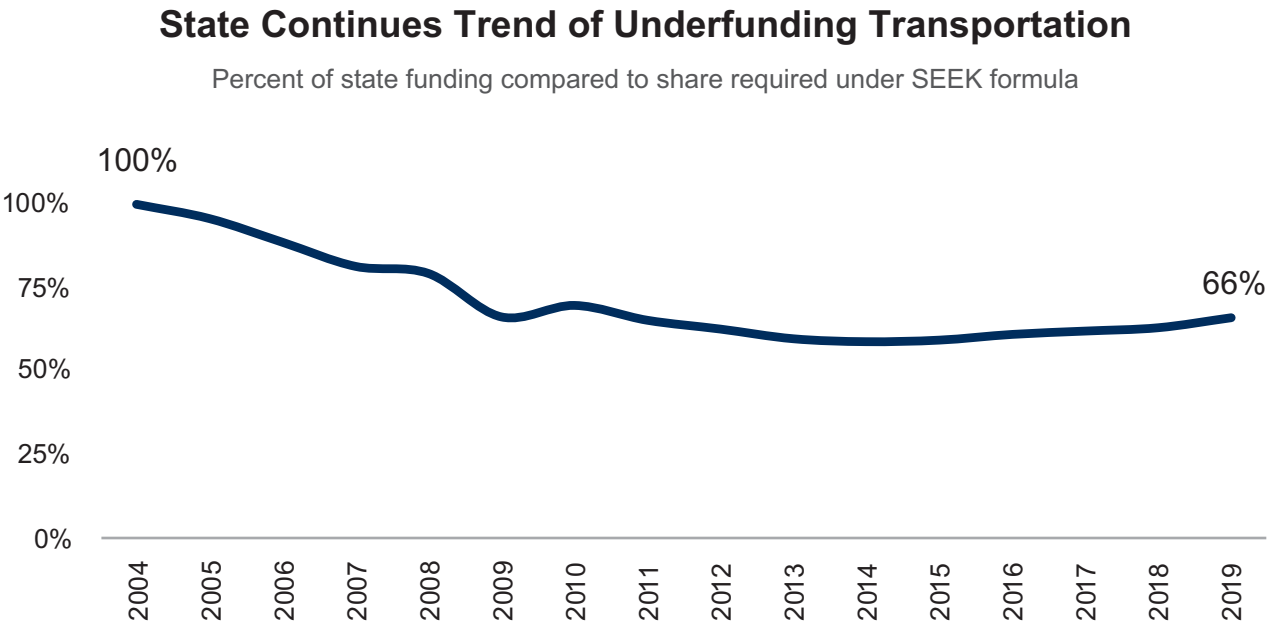
### SEEK Per-Pupil Guarantee Funding Declining in Real Dollars

State and local portions of per-pupil guarantee as enacted in 2019 dollars



Source: KCEP analysis of Office of the State Budget Director (OSBD) data as enacted.  
Note: This analysis assumes the share of funding contributed by the state versus local sources to the per-pupil guarantee each year is their share of all base SEEK funding including SEEK add-ons as well as the per-pupil guarantee. Add-ons include additional funds for students eligible for free lunches and for students with disabilities.

The cost of transportation to and from school is also a part of SEEK and is one area of the education budget that makes the cost shift to local communities especially clear. While by statute the state is responsible for 100% of school districts' estimated qualifying transportation costs, the state hasn't met this obligation since 2004. Based on estimates of transportation costs and the number of students, the 2018–2020 state budget originally funded transportation at just 60% of costs. With fewer students than expected in 2019, an additional \$31 million of SEEK funds originally appropriated for base per-pupil funding was shifted to transportation, resulting in a 66% funding level in 2019, as shown in the graph below.<sup>5</sup> The state's funding of transportation at 66% as opposed to the statutory 100% hits some rural districts particularly hard, where transportation costs are especially high.<sup>6</sup>



Source: Kentucky Department of Education. Calculation of state funding compared to share required under SEEK formula.

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## LEARNING SUPPORT FUNDING CUT DRASTICALLY

Key non-SEEK programs such as textbooks/instructional materials, staff professional development and Extended School Services (ESS) like after school programs have also been drastically cut since 2008, as shown in the table below. Even the 2008 level of investment wasn't adequate in some of these areas. For instance, though ESS has been cut by about \$8 million since 2008, it would take more than \$70 million to get it back to the level considered adequate when the Kentucky Education Reform Act (KERA) passed in 1990, once inflation is taken into account.<sup>7</sup> These areas of the budget provide critical supports in and outside of the classroom.

In addition to significant cuts to district-level supports, cuts to the Kentucky Department of Education (KDE) in the 2018–2020 budget resulted in the elimination of 25 (unfilled) positions and the nonrenewal of 17 contract positions that provide support to school districts regarding content and instruction.<sup>8</sup>

## Education Programs Have Been Deeply Cut Over the Past Decade

Funding reductions for select Learning and Results Services since 2008

	FY 2008 (originally enacted)	FY 2020	Percent Change	Inflation- Adjusted Percent Change
Instructional Resources/Textbooks	\$21,700,000	\$0	-100%	-100%
Professional Development	\$15,034,700	\$0	-100%	-100%
Extended School Services	\$31,859,500	\$23,916,300	-25%	-39%
Family Resource and Youth Services Centers (FRYSCs)	\$57,268,900	\$59,935,200	5%	-15%

Source: KCEP analysis of OSBD data. Note the FRYSCs numbers include both Department of Education and Cabinet for Health and Family Services funding. Adjusted for 2019 dollars.

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### PRESCHOOL AND KINDERGARTEN FUNDING ARE INADEQUATE

Full-day public preschool and Kindergarten lead to the best academic outcomes for children, and the benefits can even extend to better health and economic stability later in life.<sup>9</sup> In 2009, an analysis by the University of Kentucky's Center for Business and Economic Research found there would be a \$5 benefit for every \$1 the state invested to expand the state's preschool program.<sup>10</sup> Studies have found that children who attend full-day Kindergarten learn more in reading and math than children who attend half-day programs. However, the state does not adequately fund these programs, and preschool funding was not spared from cuts in the 2018–2020 budget.

Preschool funding was cut from \$90 million in 2018 to \$85 million in 2019 and 2020. Additionally, \$7.5 million of the preschool budget each year was set aside to pilot child care and preschool full day opportunities, leaving just \$77 million for the core preschool budget, 15% less than what was budgeted in 2018.<sup>11</sup> Although seeking full-day care for preschool-aged children is important, additional funds should be used to pursue those opportunities rather than redirecting core funds from a budget that does not allow for universal preschool—especially as preschool enrollment has been growing.<sup>12</sup>

Eligibility for tuition-free preschool is currently restricted to families with incomes below 160% of the poverty level (\$41,200 for a family of 4).<sup>13</sup> In the past, the KDE has advocated for the expansion of preschool eligibility without payment of tuition to 200% of the poverty level, which past estimates show would cost \$79 million each year.<sup>14</sup>

While full-day preschool in Kentucky has been shown to be more effective than half-day preschool in preparing children for Kindergarten, just 40% of school districts offer full-day, largely because of funding challenges.<sup>15</sup> As of 2017, school districts were spending \$4,395 more per child on average than they received from the preschool funds allocated by the General Assembly.<sup>16</sup>

Likewise, though full-day Kindergarten is more effective in promoting academic success than half-day programs, the state only provides funding for half-day Kindergarten. Because of the clear academic advantages, almost all school districts offer a full-day program, causing significant budgetary strain for many.<sup>17</sup> KDE is requesting an increase of \$140 million a year, or \$280 million over the 2020–2022 biennium, to fund full-day Kindergarten across the state.<sup>18</sup>

## CONTINUED NEED IN THE CHILD CARE ASSISTANCE PROGRAM

Although funding and administration of child care assistance lies within the Cabinet for Health and Family Services, child care can be considered as a part of the continuum of education because it has such profound effects on a child's academic career and outcomes even into adulthood. Approximately 28,700 Kentucky kids benefit from the Child Care Assistance Program (CCAP), which provides help with child care costs for low-income families.<sup>19</sup> The 2018–2020 budget included a \$21 million increase in funding to raise the eligibility threshold for families from 150% of the 2011 poverty line to 160% of the current federal poverty level (FPL), or \$41,200 for a family of 4 in 2019.<sup>20</sup>

In early 2016, the state increased the rate to providers by 5%, or by about \$1 per child per day. It was the first increase since 2006. The state then increased reimbursement rates for providers in counties receiving less than the 40th percentile of market rates. An influx of \$42 million in federal funds late in 2018 also helped to bolster the program.<sup>21</sup> The federal funds allowed Kentucky to raise the eligibility threshold at redetermination to 200% of FPL (\$51,500 for a family of 4), meaning families can earn additional income while participating in the program and not be at risk of losing child care assistance until they hit a higher income than before.<sup>22</sup>

These dollars were a helpful step toward expanding child care options in the state, as many child care centers closed in the wake of the Great Recession and subsequent moratorium on CCAP participation in 2013. Still, half of Kentuckians live in a “child care desert” where child care is either unavailable or there are far more children than child care openings.<sup>23</sup> Increasing reimbursement rates further will help make child care centers more viable in areas where incomes are lower, child care is less affordable and CCAP eligibility is higher.

Having access to any child care is very important for both children and parents, but research has long shown that investing in high-quality child care has especially potent benefits for the children who directly benefit, their parents and society as a whole.<sup>24</sup> Kentucky still does not adequately fund child care to the level that would fully yield those benefits. The Prichard Committee's “Cost of Quality” study estimated that \$88 million more was needed for child care assistance in the 2018–2020 budget in order to achieve a reasonable standard of quality.<sup>25</sup>

## MODEST FUNDING INCREASES IN A COUPLE EDUCATION AREAS

Modest additional funding was provided in the 2018–2020 budget for Family Resources and Youth Services Centers (FRYSCs), which work to minimize the impacts of hunger and poverty on student learning. These resources enabled an additional 40 centers to open between 2018 and 2020, and provided a very small increase in funding from \$170 to \$181 per student (not accounting for inflation), still well below 2008 funding of \$210 per student.<sup>26</sup> The additional funds also enabled more centers to be open full time.<sup>27</sup>

The 2018–2020 budget also included some additional funding for Safe Schools—a \$2.6 million increase from the previous year, which is a 25% increase in funding. After adjusting for inflation, it's a 2% increase in funding for the program since 2008.<sup>28</sup>

## WEAK STATE RESOURCES LEAD TO COST-SHIFT TO LOCAL DISTRICTS

When state funding is cut, school districts can match resources to expenditures by raising funds locally, making cuts to staff, academic programs and services, or a combination of both.

KCEP’s survey of the impact of state funding cuts between 2008 and 2017 on school districts showed that many districts have had to reduce course offerings, school-based services, the number of staff, the number of instructional days and more.<sup>29</sup> Some districts have pushed more costs onto parents through instructional and extracurricular fees—a form of school funding that disadvantages poorer districts and families.

According to our survey, as a result of state funding cuts between 2008 and 2017:

- More than half of responding districts had fewer days in the school calendar,
- 42% had reduced student supports such as after school, summer school and intervention/enrichment services,
- About a third each had reduced or eliminated arts and music programs; begun collecting or increased instructional fees; and begun or increased fees for extracurricular activities,
- 1 in 4 had reduced or eliminated career and technical education, the same share that were spending less on health services,
- More than 1 in 10 had reduced special education services, and
- Districts also report reducing staff, being unable to give needed raises, having trouble providing instructional materials, and having inadequate transportation funding and unmet facilities needs and maintenance costs.

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“Public education is a key element to a strong workforce and economic development, and if we expect to thrive, we must commit to invest. But school districts are grappling with deep past cuts and the upcoming budget will be critical. Should the trend from the last budget cycle continue, many districts would be forced to increase fees, make cuts to programs for students, courses, extra-curricular activities and a whole lot more.”

—Kathlyn Burkhardt, Ed.D.,  
Superintendent Erlanger-Elsmere Schools

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Further confounding these funding issues for districts in coal counties is that receipts from unmined mineral taxes and tangible personal property taxes have declined due to the shrinking coal industry and changes to assessments for unmined minerals in the 2016–2017 school year.<sup>30</sup> To help address the diminished tax base and revenue-raising capacity in 31 coal county districts, the 2018–2020 budget provided \$7 million in excess SEEK funds from 2018 (the excess due to lower than expected enrollment) to fund small grants.<sup>31</sup> However, this was modest one-time help and these districts continue to struggle going into the next budget.

It’s also notable that districts across the commonwealth are experiencing an unprecedented demand on already strained resources related to the rising number of children with learning disabilities and developmental delays connected to the opioid epidemic.<sup>32</sup> That trend increases the need for additional support staff, strengthened academic interventions and fully-equipped FRYSCs.

## SCHOOL FACILITIES NEEDS ARE SIGNIFICANT

Kentucky school children need a comfortable and safe environment in which to learn. However, the state’s school districts are struggling to address critical facility needs as resources fall short and needed repairs and renovations continue to add up. The School Facilities Funding Commission (SFCC) identified over \$7 billion in unmet facilities need among Kentucky’s school districts.<sup>33</sup> Unmet need is the difference between total facilities needs identified in district capital plans, excluding discretionary projects, and the local revenues available to meet those needs. The SFCC requests approval to make offers of assistance to school districts in each budget,

and makes them equitably based on unmet need. Because this typically does not provide enough capacity for districts to undertake costly projects, they are permitted to escrow SFCC offers of assistance for up to eight years to accumulate capacity. In addition to the regular offers of assistance, the General Assembly has approved an average of \$100 million a biennium in bonding capacity as urgent need funding for selected school districts that had more immediate needs than could be met with local resources.

Of the districts participating in KCEP's P-12 funding survey, 67% provided information about facilities needs; 74% of these respondents reported greater facilities needs in their most recent facilities plan than in 2008 (plans are required every 4 years unless a district is granted a waiver). This result is not surprising in light of the overall lack of state resources devoted to capital needs. There has not been a comprehensive ranking system to identify schools with the greatest capital needs, but KDE is currently in the process of implementing a new inventory and ranking system for all school facilities. When completed, the Kentucky Facility Inventory and Classification System (KFICS) will provide an inventory and ranking of existing buildings. In the most recent report filed with the Legislative Research Commission, 67 school districts had submitted at least one building inventory, and 263 facilities were included, with a significant number of additional schools and districts anticipated to be added by the end of the fiscal year.<sup>34</sup>

## FUNDING MATTERS

School funding matters, making a difference today for children and in the long term for the health and economic well-being of our state. Research utilizing up-to-date methodologies shows school funding adequacy impacts students' academic and economic success down the road, and greater investments in education can lead to a healthier state.<sup>35</sup> For instance, one study found that when school spending increased by 10% over the 12 years a low-income child was in attendance, that child was less likely to be poor as an adult, more likely to graduate from high school and had more than a 7% increase in earnings as an adult.<sup>36</sup> Another study found the achievement gap between rich and poor students shrank by around 20% in school districts located in states where funding reforms took place to address wealth inequities among districts; the gap grew in states where there was no funding reform.<sup>37</sup>

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“Our public schools impact the lives of more Kentuckians than almost anything else our legislators fund, but state investment in our students has fallen in recent years, resulting in a situation that is not adequate or equitable across communities. Our students simply must receive a bold new investment in the next two years to get us moving toward the ambitious goals we have set for their success and safety.”

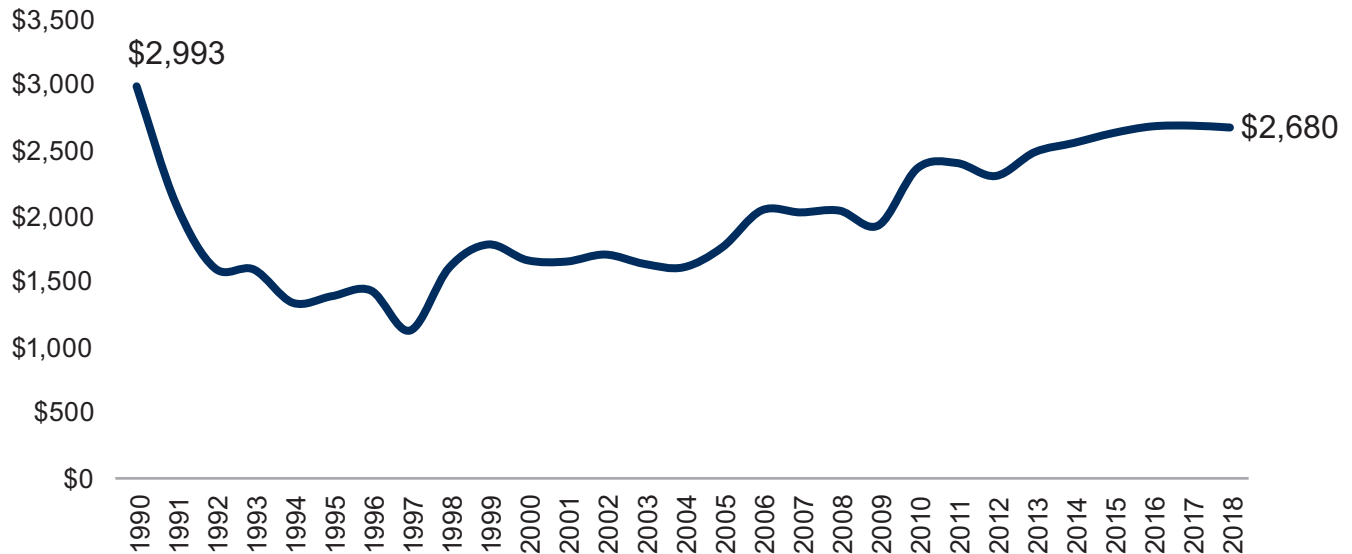
—Kerri Schelling, Executive Director,  
Kentucky School Boards Association

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Kentucky has benefitted from such reforms in the past. KERA established a funding formula that provides more state funding to school districts with less ability to raise revenue locally, equalizing funding among property rich and property poor districts. After the passage of KERA, funding disparities among districts were reduced and national achievement rankings improved. Unfortunately, due to budget cuts and an increasing reliance on local districts to generate needed revenues—the poorer of which struggle to offset lost state revenue—equity gains made through KERA are being lost.<sup>38</sup> In fact, in 2019—on the 30th anniversary of the Rose decision, the court ruling that led to KERA—Kentucky was close to pre-KERA levels of inequity among districts.<sup>39</sup> And Kentucky is losing ground on some academic gains as well.<sup>40</sup>

## The Funding Gap Between Kentucky's Poorest and Wealthiest School Districts Continues to Grow

Gap between top and bottom school district quintiles in per-pupil, state and local revenue  
(inflation-adjusted 2018 dollars)



Source: Kentucky Office of Education Accountability (1990–2010); KCEP analysis of KDE and Bureau of Labor Statistics (BLS) data (2011–2018).

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### PRESSURE FOR DOLLARS IN NEXT SESSION

It would take hundreds of millions of dollars, accounting for inflation, just to get Kentucky back to the level of investment the state was making in P-12 education in 2008. To implement what research identifies as best practices in teaching and learning—such as reducing class sizes and providing additional student support staff and services—a 2014 report from the Council on Better Education indicated that as much as \$2.4 billion a year is needed.<sup>41</sup>

Achievement gaps are prevalent in P-12 education in Kentucky, and additional resources could help to address them. Statewide test scores continue to show too many Kentucky children, most of them students who are poor and/or students of color, are struggling to master reading and math basics.<sup>42</sup> In 2019, 152 schools had gaps of 20 points or more between African American students and white students, including 49 schools with gaps of 30 points or higher. Two schools had gaps of 40 or more points.<sup>43</sup>

Meanwhile, a lack of raises for teachers and threats to their pensions have contributed to reports of fewer teachers to fill jobs.<sup>44</sup> There have been very few state-mandated teacher raises in the past decade, and when these do occur, it often falls on school districts to come up with funds. The last increase, a 2% raise, was in 2016.<sup>45</sup> In the absence of state-mandated raises, some districts have provided them.

The school safety law (SB 1) that passed in the 2019 session also brings with it costs. While the law specifies that its increase in the number of school resource officers and counselors in schools is contingent upon funding being

available, there are aspects of the law that require changes to physical buildings by July 2022 that are mandatory and not currently funded. School districts with the funding to do so have already hired these new personnel and are in the process of adding the necessary physical safety features, while some may have previously had them in place before the new law and others cannot afford to implement them. The Kentucky School Boards Association estimates it will cost at least \$18.2 million for districts to meet the minimum facility requirements of the new law.<sup>46</sup> To hire the additional school resource officers and school counselors outlined in the new school safety law would cost an estimated additional \$121 million a year just to cover salaries (this does not include benefit costs, which would be substantial). And there are other costs associated with the law's implementation such as new required staff training; the creation, training and implementation of threat assessment teams in each school; and the development and implementation of a trauma-informed approach to education.

KDE is requesting a total of \$462 million in additional funding in 2021 and \$466 million in 2022 (compared to the 2018–2020 budget) in order to provide full funding for transportation (\$162 million); a 2% increase to base SEEK to support inflation costs (\$60 million); an additional \$1.5 million for the Kentucky School for the Blind and the Kentucky School for the Deaf to make up for damaging past cuts; \$13 million to restore the cut to preschool made in the last budget; \$12 million for restoring professional development and \$17 million for textbooks/instructional materials; and \$140 million for full-day Kindergarten, as mentioned previously.<sup>47</sup>

## CONTINUED HIGHER EDUCATION CUTS DRIVE STATE'S COLLEGE AFFORDABILITY PROBLEMS

Overall, people with more education tend to have better health outcomes; and those without a college degree are more likely to have poor health.<sup>48</sup> This relationship results in part because individuals with more education are likelier to be economically secure and live in neighborhoods with fewer health risks, among other factors.

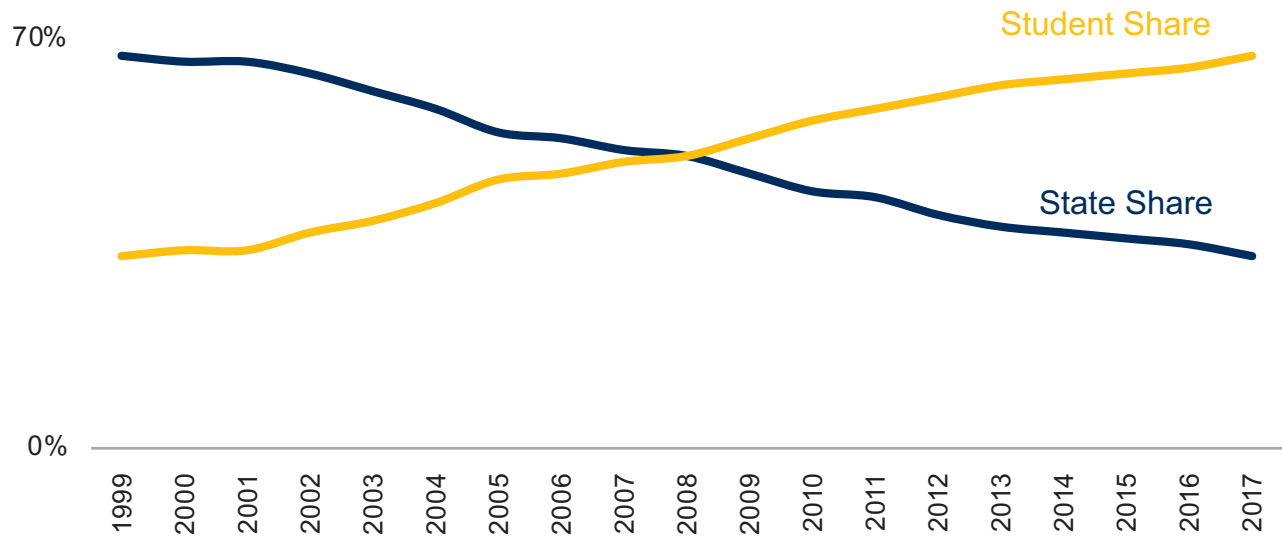
But it has become increasingly difficult for Kentuckians attending a public university or community college to afford the cost of attending. Rising costs are largely the result of large cumulative cuts in state funding for higher education institutions, tuition increases to offset the cuts, and inadequate funding for need-based scholarship programs.

Most states have begun to reinvest in higher education over the last couple of years, but Kentucky is one of the few that has continued to cut higher education funding.<sup>49</sup> Compared to before the Great Recession, Kentucky's public universities and community colleges are receiving 35% less in overall state funding in 2020 (approximately \$235 million less) once inflation is taken into account.<sup>50</sup> As a result, they have reduced faculty and staff, cut programs and made other changes that directly impact the quality of education and the supports provided to enhance student success.<sup>51</sup>

The most recent cuts in the 2018–2020 budget are part of a more than decade-long trend during which the cost of public higher education has shifted from the state to students. As shown in the graph below, the state's share of funding for postsecondary education declined from 50% in 2008 to only 33% in 2017. Average net cost at the state's public universities increased an inflation-adjusted \$2,943 between 2008 and 2018 (39.9%).<sup>52</sup>

## Cost of Higher Education Shifting from State to Students

State and student shares of total postsecondary funds in Kentucky



Source: OSBD and Council on Postsecondary Education.

Note: Net General Fund share compared to gross tuition and revenue share.

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According to a report by the Center on Budget and Policy Priorities, Kentucky ranks eighth-worst among states in college affordability, measured as average net price at a public four-year university as a share of median household income.<sup>53</sup> And the cost of higher education as a share of income is especially high for black and Hispanic families. In 2017, the average net price at a public four-year university accounted for:

- 29% of median household income for white Kentucky families,
- 40% of median household income for black Kentucky families, and
- 34% of median household income for Hispanic/Latino Kentucky families.

As tuition continues to increase while wages have not, student debt also continues to rise.<sup>54</sup> The share of students graduating with debt from 4-year universities in Kentucky (both private and public) has grown from 52% in 2004 to 64% in 2018.<sup>55</sup> And the average amount of debt for these graduates has increased from \$14,250 to \$28,435, a 50% increase once inflation is taken into account.<sup>56</sup> Black Kentucky students borrow at a higher rate than white Kentucky students, and they had higher amounts of debt as well.<sup>57</sup> A growing body of national research shows how student debt and the racial wealth gap reinforce each other, with black families facing generational wealth disparities borrowing more, and experiencing more negative financial impacts after graduating including student loan default and high loan balances.<sup>58</sup>

For some potential students and their families, the combination of static incomes and increasing costs of tuition, fees, housing, food, and other necessary living expenses, has put higher education out of reach.<sup>59</sup> And many who initially enroll do not complete their degree for financial reasons.<sup>60</sup>

In addition to tuition increases, in order to try to make up for state funding reductions, Kentucky universities and community colleges have made cuts to academic programs, faculty and staff positions, and student services that support the success of low-income students and students of color. In 2018 alone, state budget cuts resulted in the elimination of 153 positions and a long list of academic programs at Eastern Kentucky University (EKU). An academic college was closed and 140 jobs were cut at Western Kentucky University (WKU), Northern Kentucky University (NKU) eliminated 63 positions, and Morehead State University (MoSU) eliminated 26 positions.<sup>61</sup>

Recent data shows a promising uptick in credential and degree attainment in the state's public and private postsecondary institutions, including for students of color. However, additional budget cuts in the next biennium could threaten these gains. And there is much more work to be done—particularly, removing barriers to degree attainment for students with low incomes and black, non-Hispanic students.<sup>62</sup>

## PERFORMANCE FUNDING MODEL DISADVANTAGES INSTITUTIONS SERVING MORE LOW-INCOME STUDENTS AND STUDENTS OF COLOR

While the 2018–2020 state budget cut public postsecondary education institutions across the board by approximately 6% (or about \$56 million), the state also implemented a new performance funding model and placed \$31 million into the performance funding pool for which colleges and universities compete. Resources in the pool are distributed through formulas (one for universities and one for community colleges) that include student success outcomes such as degree completion as well as metrics related to volume such as the number of student credit hours earned.<sup>63</sup> While additional weights are provided for low-income and “underrepresented minority” students in the models, these weights do not fully account for the ways that economic challenges create barriers for these students.<sup>64</sup> At the same time colleges and universities do not have adequate state funding to provide needed supports to students who face hurdles to academic success, performance funding pits institutions against each other in a competition for scarce resources.

The performance funding model was designed to phase in over three years. State legislation establishing the formulas did not require that any funds be redistributed based on performance in 2019 and no more than 1% of an institution's state funding can be lost due to performance in 2020. Furthermore, Kentucky State University (KSU) and MoSU were “held harmless” for 2019 and 2020, meaning they would not lose funds due to performance.<sup>65</sup> Yet because of the way the program phases in amidst across-the-board cuts, the budget

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“As state investment in postsecondary education continues to erode, the cost of higher education is increasingly borne on the backs of Kentucky youth. We have heard from students working more than 35 hours per week, living out of their cars, and going hungry while attending college in order to be able to afford it. We know postsecondary education is the surest hedge against economic insecurity and also the surest guarantee of a vibrant, engaged citizenry. And by that measure, we know, too, that Kentucky can do a much better job of investing in us.”

—Laney Taylor (Centre), Afi Tagnedji (UofL) and Lakin Dillingham (EKU), Prichard Committee Student Voice Team

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essentially enables institutions that do well on the performance metrics to mitigate some of the funding cuts, while institutions that are disadvantaged in the model—such as small schools and those serving students with low incomes and students of color—receive little to no performance funds.<sup>66</sup>

Among those receiving no performance monies in either year of the current biennium are the state's historically black public university, KSU, and institutions serving eastern Kentucky including MoSU and several of the region's community and technical colleges. It's also notable that in 2020, the University of Kentucky received 48% of the available performance funds.

By statute, in 2021, 2% of institutions' base funds are at risk of transfer based on performance, and in 2022 the phase-in ends and all base funding for the state's public universities and community colleges will be determined using the formulas. The Kentucky Council on Postsecondary Education (CPE) has recommended that the General Assembly act in 2020 to maintain this "stop loss" at 2% in 2022 to avert "fiscal cliffs" at KSU and MoSU.<sup>67</sup> If these two universities are not protected in some way (barring unanticipated large gains in performance at these institutions) CPE notes "it is estimated that KSU would lose more than a third of its funding that is available for educating students and MoSU would lose almost 8% of its similar funding."<sup>68</sup>

CPE is requesting \$52 million in 2021 and \$75 million in 2022 for additional performance funding in the state budget: "CPE staff and campus officials do not believe that the rates of growth in degree and credential production seen over the past two years are sustainable without an infusion of new funding. State reinvestment in postsecondary education is also important to help maintain affordability for Kentucky citizens."<sup>69</sup>

In July 2020, the performance funding working group is expected to convene to conduct a comprehensive review of how the model is working, and whether changes are needed.<sup>70</sup>

## NEED-BASED FINANCIAL AID IMPROVED BUT STILL BELOW COMMITMENT

Research indicates that financial aid targeted at low-income students can boost college retention rates and increase the share of low-income college graduates.<sup>71</sup> There are three primary state-level scholarship programs that are funded through lottery proceeds. Two of the programs, the College Access Program (CAP) and Kentucky Tuition Grant (KTG), are need-based and the third, the Kentucky Educational Excellence Scholarship (KEES), is merit-based.

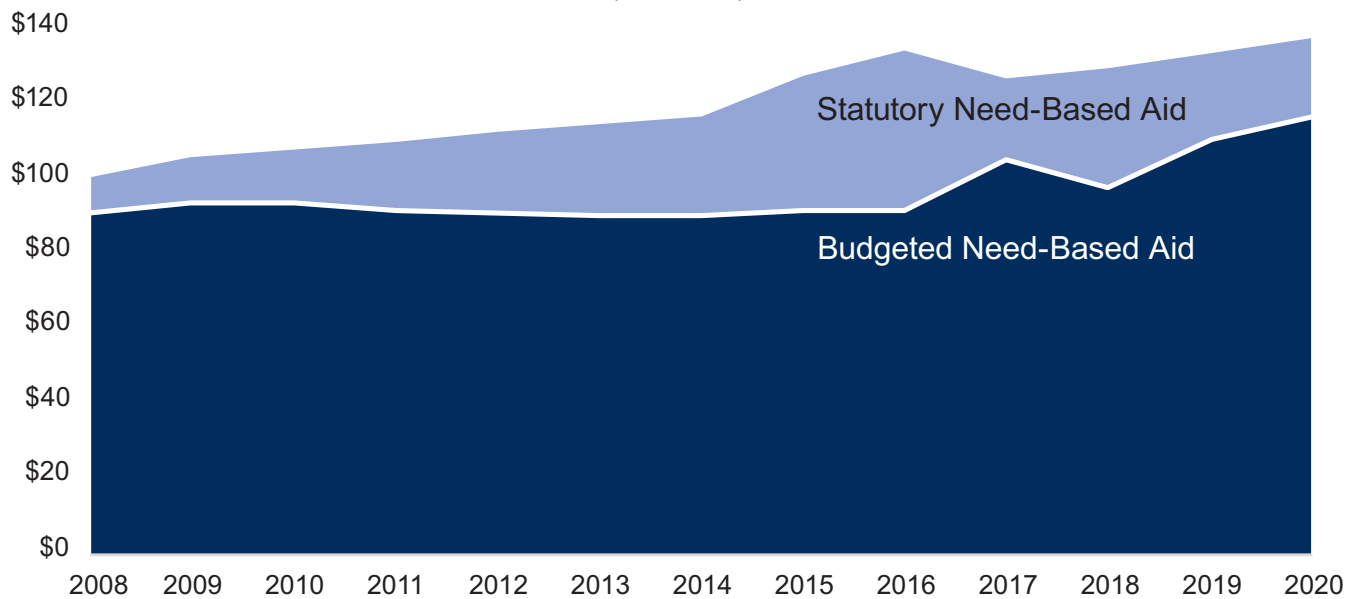
At the same time Kentuckians face steep tuition hikes at our public universities and community colleges, the lottery-funded, need-based financial aid programs are not fully funded. Thousands of students who qualify for aid are being turned away each year due to a lack of funds. By statute, all but \$3 million of lottery revenues are devoted to the state's 3 main scholarship programs, but for over a decade, a growing amount of lottery proceeds have instead been diverted to the General Fund to pay for other state priorities because of insufficient tax revenues. By statute, 55% of the lottery money is supposed to go to CAP and KTG and 45% to KEES; however in 2020, the budget suspends the statute and provides just 40% to CAP and KTG (15 percentage points less than required) while KEES was fully funded.

In recent years, lottery funds have been used for other scholarships such as the Work Ready and Dual Credit scholarships described below. Although these programs are scholarships, diverting lottery funds to support them rather than providing new revenues from another source further depletes the already inadequate funding to support need-based scholarships.

Insufficient funding means many eligible students do not receive scholarships, but the 2018–2020 budget did helpfully include \$30 million more over the biennium for CAP and KTG (combined) than the 2016–2018 budget did, creating approximately 16,830 additional scholarships.<sup>72</sup> And \$15 million in surplus lottery funds in 2019, were directed to CAP and KTG as well.<sup>73</sup> In 2019 55,100 students received CAP; 12,800 received KTG; and 70,900 received KEES.

## Kentucky's Need-Based Scholarships Are Better Funded Than Before, But Still Fall Short

Statutorily required CAP & KTG appropriations vs. what was budgeted  
(In millions)



Source: KCEP analysis of Kentucky OSBD data.

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The maximum CAP scholarship amount is \$2,000 a year; For KTG the maximum scholarship (which must be used at a private college) is \$3,000.<sup>74</sup> These amounts have gone up very little since CAP was created in the 1990s, despite the increasing costs of college in Kentucky.<sup>75</sup> Students attending a Kentucky community college full time who receive CAP and the maximum Pell Grant amount still need to come up with \$4,200 annually to cover the total cost of attendance—a modest estimate that includes housing, books and transportation.<sup>76</sup>

As previously mentioned, lottery funds were diverted away from needs-based scholarships in the last budget for other programs. The 2018–2020 budget includes continued funding of \$10 million over the biennium from lottery proceeds to support the Dual Credit Scholarship program, which pays for high school juniors and seniors to earn college credit for up to 2 courses at no cost to the students. In 2019, 23,200 students received this scholarship.<sup>77</sup>

In addition, the 2018–2020 budget includes funding from the lottery for the Work Ready Kentucky scholarship. This program covers the equivalent of community college tuition and mandatory fees for associate's degrees,

short-term certificates or diplomas in five occupational areas—advanced manufacturing, business/IT, transportation/logistics, construction/trades and health care—at Kentucky community colleges, several public universities and several private institutions.<sup>78</sup> The scholarship is a “last-dollar program,” which means that because Pell Grants and other scholarships that could be used for other education-related costs are applied to a student’s tuition and mandatory fee bill first, many low-income students who receive Pell Grants do not benefit from the Work Ready scholarship, even though they still have unmet need related to non-qualifying expenditures such as room and board and supplies. This scholarship program, previously established and funded through budget language, was made permanent by legislation in 2019. In 2019, 2,250 students received this scholarship.<sup>79</sup>

The separate Work Ready Dual Credit Scholarship covers Career and Technical Education coursework for high school students that leads to an industry-recognized credential; a student can enroll in two qualifying courses per year under this scholarship.<sup>80</sup> In 2019, 5,500 students received it.<sup>81</sup>

The 2020–2022 budget request from the Kentucky Higher Education Assistance Authority includes an additional \$63 million in 2021 and \$71 million in 2022 (compared to 2020) largely due to an expected increase in net lottery funds for CAP, KTG and KEES which would be distributed according to statute.<sup>82</sup> Some additional funds are also requested for the Work Ready scholarship and the Dual Credit scholarship.

## MEDICAID WORKS AND REQUIRES GROWING INVESTMENT

Medicaid is the second-largest single General Fund appropriation in the state budget, behind only P-12 education. It makes up roughly one in six General Fund dollars and one in three dollars the state spends overall (with the latter including federal dollars that flow through the state budget). Medicaid is also among the fastest growing expenditures in the budget, as medical inflation generally grows faster than inflation in the economy at large, and as the state pays for its final increase in its share to fund Medicaid expansion. Keeping up with these costs is important, as investments in health create long-term dividends in our economy and well-being as a state.

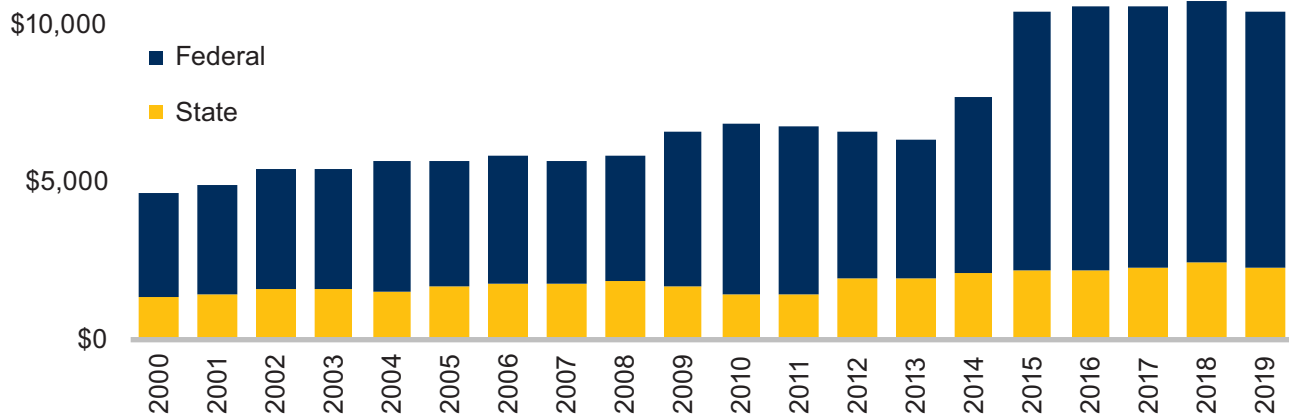
Kentucky’s Medicaid costs are almost entirely driven by three things:

- The federal share of overall Medicaid expenditures known as the Federal Medical Assistance Percentage (FMAP),
- The number of people who are covered, and
- The cost of providing medical care.

Medicaid is a great deal for the commonwealth because it is largely paid for by the federal government. Accounting for state and federal dollars, in 2019, Kentucky spent \$7.2 billion on traditional Medicaid benefits and \$2.9 billion on expanded Medicaid benefits for a total of \$10.4 billion. Of that, the state was responsible for \$2.3 billion in combined General Fund and restricted agency funds. This means that for every state dollar invested in Medicaid in 2019, the federal government invested \$3.46.

## Medicaid Is a Good Deal for Kentucky

Inflation adjusted by the CPI-U in 2019 dollars  
(In millions)



Source: KCEP analysis of LRC Medicaid Benefits Expenditure Report & BLS data.

Note: State share includes both General Fund and Restricted State Agency appropriations.

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There are actually two FMAPs for Kentucky—one for traditional Medicaid and a more generous FMAP for expanded Medicaid. For traditional Medicaid, the federal share of costs depends on the economic well-being of each state, and ranges from around 50% to just under 75%. Kentucky's has been around 70% for several years, but starting next fiscal year Kentucky's FMAP will increase from 71.67% to 71.82%, which, though seemingly small, will reduce what Kentucky will pay for traditional Medicaid by millions of dollars.

Separate from traditional Medicaid, the expansion has what is known as an enhanced FMAP. For the first three years of the expansion, the federal government paid all costs. Since then, the state's share has been phasing up to a maximum of 10%—in full effect in calendar year 2020 and thereafter. This means that the first year of the next budget will include the final increase of approximately \$50 million, and a total increase of approximately \$150 million across the biennium compared to the previous biennium.

## Last Major Medicaid Expansion Increase Is Next Fiscal Year

Enhanced FMAP for Medicaid expansion

	Federal Share	State Share
2016	100%	0%
2017	98%	3%
2018	95%	6%
2019	94%	6%
2020	92%	9%
<b>2021</b>	<b>90%</b>	<b>10%</b>
<b>2022</b>	<b>90%</b>	<b>10%</b>

Source: OSBD.

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State Medicaid costs in 2019 were lower than expected, with much lower enrollment than the 2018–2020 budget projected for both traditionally eligible and expansion eligible populations; 140,000 fewer people were covered by the end of the year than was expected. Due to this decline in enrollment, which started at the beginning of the last biennium, the state spent \$881 million less than what was budgeted.<sup>83</sup>

It is not yet entirely clear what is driving declining participation in Medicaid in Kentucky, and if enrollment will increase again in the next biennium. While the slow-but-steady economic recovery has contributed to a reduction in Medicaid enrollment, the decline has been more dramatic than broader economic indicators like the falling unemployment rate would suggest.<sup>84</sup> The decline in Medicaid enrollment has occurred for adults and children alike, at -5.5% and -2.2% respectively between December 2017 and December 2018. The total reduction is -4.1%, which is the 11th largest enrollment decline in the country and nearly double the national rate.<sup>85</sup>

There is reason to believe that federal and state administrative actions have contributed to this decline, including among children, and that those actions have also contributed to an increase in the number of uninsured.<sup>86</sup> State data has shown that thousands are disenrolled from Medicaid coverage each month because of paperwork issues, and it is not clear why.<sup>87</sup>

In addition to the changing FMAPs, one major change to Kentucky's Medicaid budget outlook in the 2020-2022 budget is the withdrawal of Kentucky's proposed barriers to coverage through an 1115 waiver.<sup>88</sup> The plan would have covered between 95,000 and 135,000 fewer Kentuckians by ending coverage for failure to meet a work reporting requirement, failing to pay premiums, failing to report changes in income in a timely fashion or failing to complete annual redeterminations within a specific timeframe.<sup>89</sup>

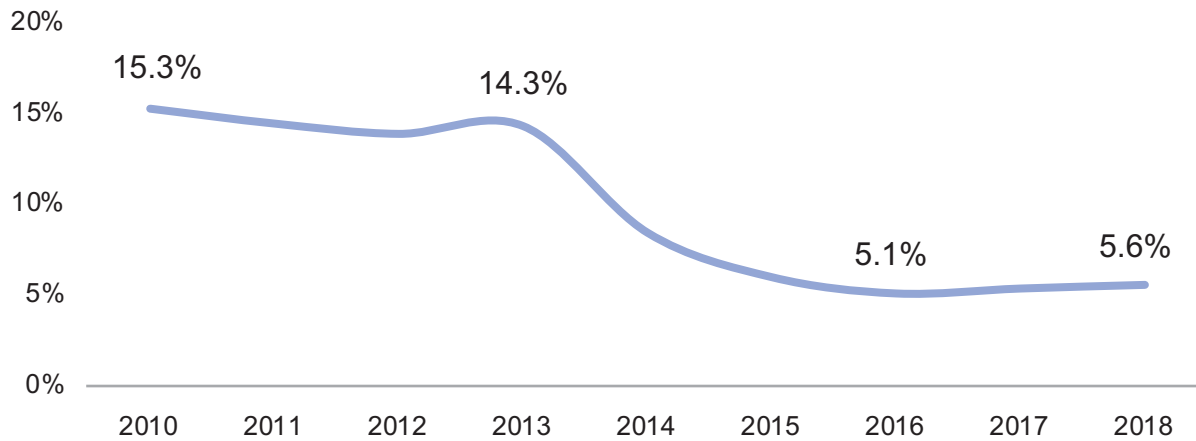
This plan would have unraveled much of the progress the expansion has made in our health and economy. In addition to taking away health care, it also would have cost over \$270 million total in administrative costs (over multiple biennia), a portion of which would have been state costs. In fact, the state has already paid \$100 million preparing to implement these barriers in combined state and federal funds.<sup>90</sup> The withdrawal of this plan means Kentucky will pay less in Medicaid administration overall and continue to benefit economically from federal dollars that come from covering more Kentuckians.<sup>91</sup>

## MEDICAID IS A CRUCIAL INVESTMENT

Low-income Kentuckians are benefitting greatly from the state's 2013 decision to expand Medicaid eligibility through the Affordable Care Act (ACA) to 138% of the federal poverty line (\$17,230 in annual earnings for an individual).<sup>92</sup> More than 450,000 Kentuckians are enrolled in Medicaid coverage through the expansion, roughly a third of the total Medicaid population (1.3 million).<sup>93</sup> The expansion is the major reason Kentucky's rate of uninsured dropped from 14.3% in 2013 to 5.1% in 2016, the biggest decline in the nation.<sup>94</sup> Since that time, the rate of uninsured Kentuckians has crept back to 5.6% as Medicaid enrollment has fallen by tens of thousands.<sup>95</sup>

## Kentucky's Rate of Uninsured Plummeted, But is Rising

Percent of Kentucky non-institutionalized population without any form of health coverage



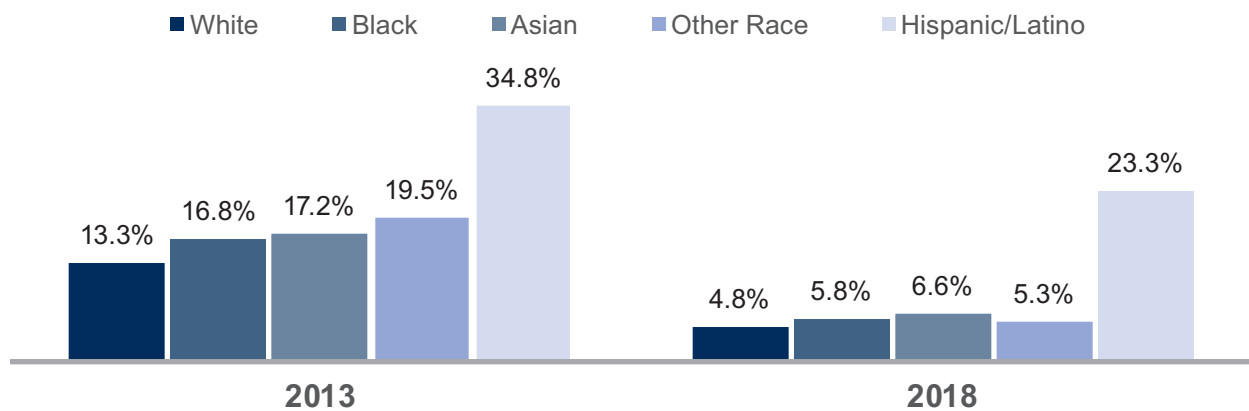
Source: American Community Survey (ACS) 1 year estimates data 2010–2018.

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This deep reduction in the share of Kentuckians without insurance was also a significant tool for reducing the racial disparity in coverage. The reduction in uninsured Kentuckians between 2013 (the year before the ACA's coverage programs were implemented) and 2018 for Kentuckians of color was even greater than among white Kentuckians. In fact, with the exception Hispanic/Latino Kentuckians, the disparities were cut in half.<sup>96</sup>

## Health Care Gains Have Slashed Disparities in Coverage

Uninsured rate for non-institutionalized Kentucky population by race and Hispanic/Latino ethnicity



Source: KCEP analysis of 2013 and 2018 ACS 1 year estimates.

Note: White, Black, Asian and Other Race categories are non-Hispanic.

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As a result of the expansion, use of a primary care physician, regular care for chronic conditions, and screenings for health problems like diabetes, cancer and hypertension have all substantially increased. This greater use of care has already begun to translate to better health, with preventable hospitalizations dropping for asthma and hypertension, fewer Kentuckians smoking, a lower rate of infant mortality and breast cancer deaths and

a growing share of Medicaid expansion-eligible Kentuckians reporting excellent health.<sup>97</sup> One recent study estimated that, because Kentucky expanded Medicaid eligibility and covered hundreds of thousands more people, over 700 lives were saved between 2014 and 2017.<sup>98</sup> A prime example of how Medicaid expansion saves lives comes from a University of Kentucky study finding that a 230% increase in colorectal cancer screenings in Kentucky following Medicaid expansion led to a 9.3% increase in early cancer detection, and a 27% decrease in the risk of death among those who were diagnosed.<sup>99</sup>

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“Family Health Centers rely upon a number of local, state and federally funded programs to help support our primary care services to more than 44,000 underserved Kentuckians. Medicaid has been the single largest source of revenue for health centers in Kentucky, particularly for federally qualified health centers.”

—Bill Wagner, Chief Executive Director at Family Health Centers of Louisville

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The ACA has also improved access to mental health and substance use services for low-income Kentuckians and reduced the necessity of state funding for these services that are now covered by Medicaid. Between the first quarter of 2014 and the last quarter of 2016, Medicaid-covered treatment for a substance use disorder rose over 500%, from 2,772 treatments to 16,791.<sup>100</sup>

The new influx of covered patients through Medicaid has also resulted in a nearly \$2 billion decrease in uncompensated care at hospitals. This decrease in uncompensated care and a broader increase in revenue resulting from the Medicaid expansion have contributed to the private health care and social

assistance sector growing by 22,000 jobs in Kentucky since January 2014—for a total job growth rate of 9.7% (3.7 percentage points more than the equivalent period pre-expansion) compared to 7.9% for all other private sector jobs.<sup>101</sup> A thriving health care sector is an economic driver for the rest of the commonwealth, as every \$1 invested results in \$1.50 to \$2 circulating in the economy at large.<sup>102</sup>

## WAITING LISTS ARE LONG FOR KENTUCKIANS WHO NEED CARE AT HOME AND IN THEIR COMMUNITY

Through a different kind of waiver program, traditional Medicaid pays for in-home care for individuals with significant health care needs such as intellectual or developmental disabilities and brain injuries. Referred to as 1915c waivers, these programs are vital to supporting Kentuckians with disabilities so they can stay in the community rather than in nursing homes or state-run institutions, which are more expensive and less desirable for many people.

In the last budget, there were two improvements to the 1915c waivers. First, after years of stagnation, provider reimbursement rates were increased by \$10.5 million each year, which drew down an additional \$25 million in federal funds within the Supports for Community Living (SCL) waiver program, which provides home and community-based care for individuals with intellectual and developmental disabilities. This increase was important because many providers were struggling to offer services because they were operating at or below cost. Further funding stagnation threatened to end services for the thousands getting care at home or in their community through SCL.

The budget also provided \$2.6 million—which drew down an additional \$6.3 million in federal funding—to open 118 new slots for the long-term Acquired Brain Injury Waiver program. This helped reduce the waiting list for that program from 207 in 2017 to 91 in 2019.

Even with some additional funding for the home and community-based services waivers, waiting lists have grown since the last biennium. This growth was driven entirely by increases in Kentuckians seeking services through the Michelle P (community and home-based care for Kentuckians with intellectual or developmental disabilities) and SCL programs, for which waiting lists have increased by a collective 1,300 people. Not everyone on a waiting list is actually eligible for a slot, so the number of people who could actually receive services through these programs is likely smaller. But in total, a lack of sufficient state funding has led to nearly 9,400 people waiting for the state to tell them if they can receive these services.<sup>103</sup> Three of the six programs have no waiting list: Acquired Brain Injury (Acute), Home and Community Based (community and home-based care for older Kentuckians, children and adults with disabilities), and Model II (community and home-based care for Kentuckians who are ventilator dependent).

### Thousands of Kentuckians with Disabilities Still Waiting for Care in their Homes and Communities

Medicaid 1915c waiver slots and waiting lists

Waiver Program	Funded Slots	Filled	Allocated/ Reserved	Slots Available	Total Waitlisted
Acquired Brain Injury—Acute	383	211	72	100	-
Acquired Brain Injury LTC	438	261	62	115	91
Home and Community Based	17,050	10,031	110	6,909	-
Michelle P	10,500	9,979	325	196	6,600
Model II	100	31	-	69	-
Supports for Community Living	4,941	4,845	4	48	2,692
<b>Total 1915c</b>	<b>33,412</b>	<b>25,358</b>	<b>573</b>	<b>7,437</b>	<b>9,383</b>

Source: Aug. 20, 2019 CHFS presentation to the Budget Review Subcommittee on Human Resources.

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## HUMAN SERVICES DEEPLY UNDERFUNDED

### KENTUCKY’S SOCIAL WORKERS STILL IN CRISIS

Kentucky ranks first in the nation in its rate of abused and neglected children—at 22.2 per 1,000 children. This problem creates an immense need for state services for children and families across the commonwealth.<sup>104</sup> The primary driver is an epidemic of substance use disorders, which the Department for Community Based Services (DCBS) estimates directly or indirectly has led to 70% of all foster care cases.<sup>105</sup> This crisis has overwhelmed Kentucky’s child welfare system and led to staff burnout, court cases, and significant budgetary pressures.

Social workers in DCBS, who serve on the frontline of the state’s child protection program, continue to face challenges. The best practice caseload for child welfare workers is 15-18 cases, but in Kentucky the average is 30 cases per worker.<sup>106</sup> In places like Fayette and Jefferson counties, caseloads are far higher at 60 and 80 cases per worker, respectively.<sup>107</sup> The most recent biennial budget included an extra \$22 million to give

pay raises of up to 10% for social workers in an attempt to reduce high staff turnover, but caseloads remain unsustainably high and no additional funding was given to increase the number of state caseworkers. Across the commonwealth, 9,721 children live in out-of-home care, down slightly from the high point of 9,916 at the end of 2018, but still well above the 7,900 in 2016. Despite this increase, DCBS has essentially the same number of caseworkers in 2019 (1,134) as it did in 2016 (1,136).<sup>108</sup>

Children removed from their parents or legal guardians because of unsafe conditions are placed in either kinship, fictive kin, relative foster or foster care.<sup>109</sup> Foster parents, who are trained and regulated through the state or private agencies prior to placement, receive an average of \$750 a month per child to help with the care of the child, and foster care homes have soared in recent years to 5,443 as of September 2019, compared to nearly 4,400 in September of 2014.<sup>110</sup> Relative caregivers and fictive kin should now be treated by DCBS as foster parents, and receive the same monthly stipend for the children in their care in light of *D.O. v Glisson*, in which a court ruled that relative caregiver settings are essentially the same as foster care settings. Between February 2018 and May 2019, DCBS has made nearly 21,000 payments for a total of \$17.7 million to these households, which support 3,200 children.<sup>111</sup>

In Fiscal Year 2019 (FY19), DCBS spent \$476 million on out-of-home care costs, but just \$18 million in prevention services which could reduce the number of children being taken from their parents. Approximately 96% of kids from families participating in the state's current Family Preservation Program, a prevention service, stay safely in their homes while receiving wraparound services and supports. However, only around a fifth of families that need this program have received the services due to limited income qualification requirements and insufficient funding.<sup>112</sup>

One recent development to address this imbalance is the federal Family First Prevention Services Act, which will reimburse half the state's cost of providing evidence-based prevention and family preservation services for families where a parent is struggling with a substance use disorder. Kentucky has an implementation plan, which is the first step required to draw down federal funding. It will also need additional General Fund monies in the upcoming budget in order to fully realize the opportunity that Family First provides.<sup>113</sup>

DCBS is the largest agency providing social services in state government that range far beyond the child welfare system. It plays a critical role in supporting low-income Kentuckians, and evidence suggests it plays a role in helping Kentuckians get and stay healthy. Researchers have found that higher ratio of spending on social services to public health services actually yields better health outcomes, particularly for conditions such as asthma, adult obesity, poor mental health, lung cancer, heart attacks, type two diabetes and even mortality. While the study didn't suggest an ideal ratio, it did suggest that policy-makers need to think of social service spending as a form of public health intervention.<sup>114</sup>

## OTHER HUMAN SERVICES NEEDS GOING UNMET AND BEING CUT

Kentucky's Department for Behavioral Health, Intellectual and Developmental Disabilities (BHIDD) provides a wide range of services for addiction treatment, community living for dependent adults, long-term institutional care for those with severe needs and outpatient mental health services. This division has not received a meaningful state funding increase since the 1990s and was cut by 4.3% in the last budget (though the cuts to programs within the department were likely deeper as additional funds for higher pension costs were included in the

budget). Funding has therefore failed to keep up with inflation and the growth in demand for services. The state's Community Mental Health Centers (CMHCs) are a part of the BHIDD, and they struggle to meet higher pension contributions set to rise further after this year. Among many other functions, these centers act as a drug treatment safety net, a critical service as Kentucky has the nation's 4th-highest drug overdose death rate at 37.2 out of 100,000.<sup>115</sup> This epidemic strains not just Kentucky's CMHCs, but the state's justice, child welfare and public health systems as well.

In addition to the services provided by Medicaid, Kentucky also cares for the aged and disabled through the Department for Aging and Independent Living (DAIL). DAIL administers both federally and state-funded programs that help keep dependent adults out of institutionalized care. An example is State Guardianship, which helps keep nearly 5,300 disabled adults in the community, up from 4,400 in the last biennium. Caseloads for this program should be at a standard of 20 per state worker, but average 55; this is after DAIL added 7 caseworkers for a total of 89 between FY 2018 and FY 2019 as a result of an additional \$1.6 million in the last budget added for this purpose.<sup>116</sup> Other programs administered by DAIL include Meals on Wheels, Hart Supported-Living, the Traumatic Brain Injury Behavioral Program and certification authority for assisted living and adult day care settings. The share of Kentuckians age 65 and older is projected to rise from 15.2% in 2015 to 21.6% in 2040, meaning more Kentuckians will require the services provided by DAIL. However, the department has seen no meaningful increase in funding for years.<sup>117</sup>

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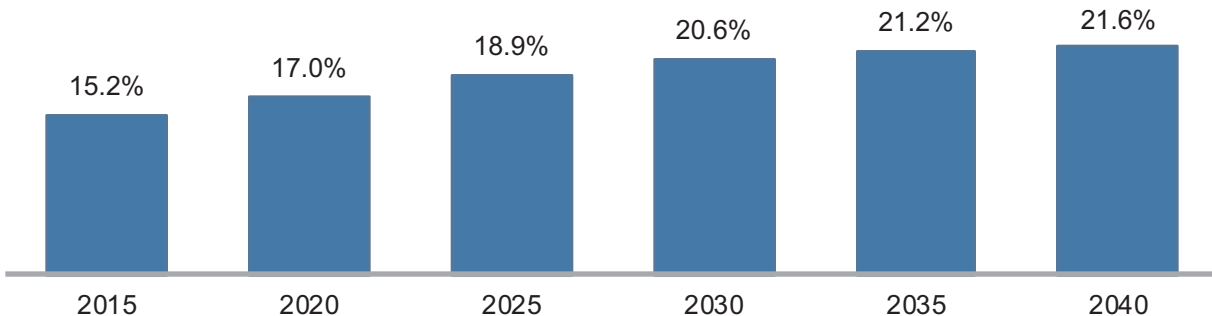
"Funds the Community Mental Health Centers receive from the DBHDID and Medicaid are vital to maintaining the behavioral health public safety for over 175,000 of our family members, friends, classmates, neighbors and co-workers throughout the Commonwealth — especially with the pressures of pension costs on the safety net."

—Steve Shannon, Executive Director of the  
Kentucky Association of Regional Providers

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## Kentucky's Older Adult Population Expected to Grow

Projected share of Kentucky residents age 65 and older



Source: KCEP analysis of Vintage 2016 Age and Gender Projections from the Kentucky State Data Center.

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# PUBLIC HEALTH EXPERIENCING DEEP CUTS AMIDST CURRENT AND POTENTIAL DISEASE OUTBREAKS

The Department for Public Health oversees a broad swath of over 150 programs and services that range from facility inspections, newborn screenings, immunizations and disease outbreak prevention. Many of these services are performed through partnerships with local health departments. Recently, after a large increase in required pension contributions and after years of underfunding, the state announced its plans to scale back the services offered by local public health departments to the bare statutory minimum with the goal of offloading those responsibilities to local private partners.<sup>118</sup> The result of this reduction of public services is a planned 600-position layoff.<sup>119</sup>

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“In the 20th century, public health practice has led to a thirty-year increase in life expectancy of the average American. But now life expectancy in the U.S. is declining for the first time since the great flu pandemic of 1918. Continued budget cuts to public health in Kentucky will only continue and exacerbate this trend. We need funding to be able to meet challenges posed by outbreaks of infectious diseases, such as last year’s hepatitis A epidemic; to be able to respond to the state’s devastating opioid crisis; and to prevent the next big epidemic before it happens. We need the resources to be able to build on past public health successes to improve community health and to help usher in the day where everyone and every community thrives.”

—Dr. Sarah Moyer, Louisville’s Chief Health Strategist and Director of the Louisville Metro Department of Public Health and Wellness

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Staff reductions of this size could be detrimental to the state’s ability to handle widespread disease outbreaks, especially those that stem from intravenous drug use. In fact, the state has already been criticized for its inadequate response to Kentucky’s recent Hepatitis A outbreak, which resulted in a third of all Hepatitis A deaths in the country since 2016. Despite requests for additional funding for staff and vaccines from local health departments, the state health department sent a quarter of what was requested and declined to declare a state of emergency, citing an insufficient budget.<sup>120</sup>

Reducing local public health department staff could also hamper the state’s already poor readiness to respond to an HIV or Hepatitis C outbreak. Kentucky has the second-worst readiness for a rapid response to an outbreak of these infections, according to the CDC. In fact, over one in four Kentuckians live in a county especially vulnerable to such an outbreak due to poor public health infrastructure.<sup>121</sup> Without significant investment in our local public health departments, the state remains vulnerable to these and other illnesses.

One evidence-based practice to reduce the spread of infections from intravenous drug use is needle exchange, but currently in Kentucky it is largely grant-

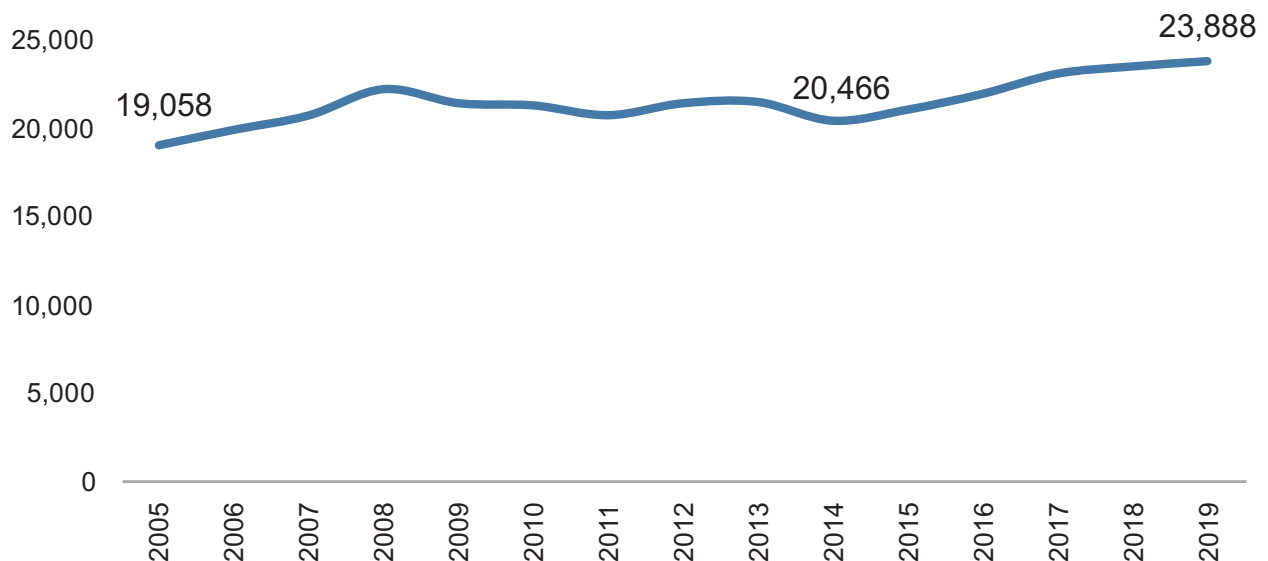
based or locally funded.<sup>122</sup> Kentucky leads the nation in the number of needle exchange sites, but only half of the 54 counties most at risk for an HIV or Hepatitis C outbreak have one.<sup>123</sup> Typically, local public health departments administer these sites but would need added state resources to expand such programs.

# KENTUCKY'S CRIMINAL JUSTICE COSTS RISE AS INCARCERATION CONTINUES TO GROW

Despite widespread agreement that Kentucky has too many people incarcerated in prisons and jails, the legislature has been unable to agree on how to move forward with criminal justice reforms to address the issue. In the meantime, the amount of money the state spends on incarcerating people continues to grow, as shown in the graph below. After declining some following criminal justice reform legislation passed in 2011 (HB 463), the number of incarcerated people has grown steadily since 2014.

## Number of Incarcerated Kentuckians Is Growing

Average daily population of individuals incarcerated for felony convictions



Source: Kentucky Department of Corrections.

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The trend is harmful to incarcerated individuals, their families and the state as a whole, while not making our communities safer.<sup>124</sup> The 2018–2020 budget appropriated \$585 million in General Fund dollars for Corrections in 2019, with an additional \$14.9 million in Necessary Government Expenses (NGEs) for higher-than-expected prison costs. For 2020, the budget appropriates \$599 million.<sup>125</sup> In comparison, in 2017 the state spent \$541 million.<sup>126</sup> (In 2018, the Corrections appropriation was \$502 million plus \$52 million in NGEs primarily for 2,400 more people incarcerated than projected and higher medical and staffing expenses.)

In 2018, the state re-opened a private prison due to overcrowding in state-run facilities. In October 2019, the governor announced the state will be leasing and operating another privately owned prison that was previously closed. These openings are primarily to address extreme overcrowding in some local jails due in part to individuals in state custody staying longer than the statutorily permitted 45 days because of lack of space in state prisons.<sup>127</sup> While this will help begin to address jail overcrowding, it will be costly to the state as corrections beds operated by the state, at an average daily rate of \$75.91, are more expensive than the \$31.34 per diem the state pays to local jails.

Ultimately, the only real solution is to reduce the number of people incarcerated through justice reforms. Yet while numerous states have passed policies that are reducing incarceration to the point that facilities can be closed and state dollars invested elsewhere, Kentucky's incarceration rate keeps growing. New policies passed by the General Assembly in recent years exacerbate the issue. Kentucky currently has the 10th-highest incarceration rate in the nation and the 2nd-highest rate of female incarceration. Kentucky also has the second-highest share of kids with a parent who has been incarcerated.<sup>128</sup>

## RECENT KENTUCKY POLICIES HAVE INCREASED INCARCERATION, STALLED REFORMS

Mass incarceration in Kentucky has been impacted by the state's substance use disorder challenges, made worse by an underfunded social services system providing insufficient treatment for those in need, criminal justice laws that treat drug possession (for substances other than marijuana) as a felony, and a low minimum of \$500 for felony theft, which is often related to an underlying substance use disorder. The lowest level felony, designated as "Class D", carries a potential 1-5 year prison sentence, which by law must be served in a county jail—most of which are so overcrowded they do not have the space or resources to provide programming. In 2017, Kentucky's prison population (including those in state custody in county jails) was projected to grow by 19% over the next decade at a cost of more than \$600 million.<sup>129</sup> And since then, the General Assembly has only passed laws that will worsen the situation:

- In 2017, HB 333 was passed, increasing criminal penalties for low-level heroin trafficking. Specifically, it erased distinctions (created in 2011) that prevented people struggling with addiction who are caught selling or even sharing small amounts to support their own habit from receiving harsh penalties for heroin trafficking. The legislation was projected to significantly increase corrections costs, with some estimates predicting upwards of \$30 million annually.<sup>130</sup> Incarceration is a poor solution to substance use disorders.<sup>131</sup>
- In 2018, 26 law changes created new crimes or increased sentences for existing crimes.<sup>132</sup> Meanwhile, just two bills eliminated crimes or reduced sentences. HB 169, the so-called "gang bill" broadened the definition of what a gang is, and increased penalties for certain crimes if the person was shown to be a gang member. Similar legislation passed in other states did not reduce crime and had a disproportionate impact on people of color.<sup>133</sup> The Legislative Research Commission's cost estimate for the bill was \$19.5 million.<sup>134</sup>
- In the 2019 General Assembly, 31 changes were made to increase the reach of or costs to the criminal justice system and just 6 changes were made to lessen the reach of or costs to the system. The latter were minor changes that will have very little impact (such as a concealed carry bill).<sup>135</sup>

Probation and parole is another area that drives incarceration, with nearly 49,000 individuals under supervision in July 2019.<sup>136</sup> Many on probation and parole end up incarcerated or re-incarcerated due to technical violations such as missing a required meeting or failing a drug test (including marijuana).<sup>137</sup> Meanwhile, the parole rate is the lowest it has been in years—with just 35% of people eligible for parole being released in September 2019. Parole rates in Kentucky in 2019 are the lowest they have been in years.<sup>138</sup>

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“While we approach a decade of talking about criminal justice reform, what we continue to do is make the problem worse with more crimes, higher sentences, and more reasons to put and keep our fellow Kentuckians in jail or prison. It’s time to put our words into practice and enact meaningful reform that will make Kentucky safe by addressing needs, not just warehousing people.”

—Damon Preston, Kentucky’s Public Advocate

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A package of commonsense justice reform policies (HB 396) was proposed in 2018 that would have addressed many of these drivers of incarceration in Kentucky. The components included pretrial reforms, increasing the felony theft threshold, making drug possession a misdemeanor and probation and parole reforms.<sup>139</sup> However, this bill did not move beyond a discussion-only committee hearing.

The only criminal justice bright spot during the last biennium was a new law passed in 2018 that expands felony expungement by including more qualifying offenses, and reduces the fee for expungement from \$500 to \$300.<sup>140</sup> In the long run, this law could result

in fewer Kentuckians returning to prison as it will enable more employment and housing opportunities for people whose records are cleared (after serving their time and not receiving additional charges for at least five years).

Reforms with a focus on racial disparities in our criminal justice system are badly needed.<sup>141</sup> Black Kentuckians are overrepresented in the state’s incarcerated population. Despite being just 8% of Kentucky’s adult population, African Americans make up 14% of all arrests in the state, 16% of arrests for serious crimes, 21% of those incarcerated for felony convictions and 30% of the confined juvenile population.<sup>142</sup> Rather than one racial group simply being more likely than another to commit crimes, the causes of the racial disparities in the criminal justice system are much more complex. Research on the topic points in part to policies and practices such as those related to the “war on drugs,” as well as implicit bias and stereotypes in decision-making, which have a disparate impact on black people.<sup>143</sup> For instance, whites (compared to African Americans) tend to face the lesser charge of heroin possession as opposed to trafficking, according to data from Kentucky’s Department of Public Advocacy.<sup>144</sup>

## SOME JUVENILE JUSTICE GAINS BUT ADDITIONAL REFORMS NEEDED

Kentucky’s experience with juvenile justice reforms provides some important lessons for moving forward with reforms to the adult system. The state has seen a dramatic decline in the number of youth incarcerated since the passage of SB 200 in 2014, with several detention centers closing, millions of dollars in cost savings to the state, and \$3.6 million reinvested in communities and related programming as reported in February 2018.<sup>145</sup> Yet while juvenile justice reforms have resulted in overall declines in youth detention, they have actually increased racial disparities, with African American youth having fewer opportunities for pre-court diversion established by SB 200.<sup>146</sup>

In both 2018 and 2019, a bill (SB 20 both years) was filed to address disparities through mandatory data reporting from related agencies, changes to the criteria for the automatic transfer of juveniles to adult court, and a new minimum age of criminal responsibility. The bill did not move beyond a stripped-down version passing committee in 2018. These reforms are greatly needed to address the disparate impact of the juvenile system on black young people as well as other issues. They would also provide savings to the state and local governments that share the costs of youth incarceration.<sup>147</sup>

Even as the state has enacted some important but limited reforms that reduce costs, budget cuts challenge the system's ability to carry out its role. The Department of Juvenile Justice testified in 2018 that past budget cuts have led to hiring freezes, reductions in staff training, and continued staff turnover due to the stress of inadequate staffing and forced overtime.<sup>148</sup> The 2018–2020 budget included funding to hire new youth workers in order to maintain a staff-to-juvenile ratio that is compliant with the Prison Rape Elimination Act.<sup>149</sup>

## INCARCERATION AND COUNTY BUDGETS

Kentucky has the second-highest share of individuals in state custody incarcerated in local jails—around 11,000 of 24,000 individuals convicted of felonies and in the custody of the Department of Corrections; only Louisiana is higher and no other states come anywhere close to these two. By state law, starting in 1992, those serving Class D felony sentences must stay in a county jail; those with Class C felonies can be housed in county jails, too, as well as any person sentenced and awaiting a prison bed.<sup>150</sup> This arrangement, in the context of state policies and practices that are driving high rates of incarceration, has resulted in severe overcrowding of local jails, which were not designed for long-term incarceration.

Although the jails have been overcrowded for many years, the situation has worsened significantly over the past few years and has been difficult to address because of perverse financial incentives that exist for both the state and the counties. It is financially beneficial to the state for individuals convicted of felonies to be held in county jails because it costs much more to incarcerate someone in a state prison. In a state facility, the average cost per day is \$75.91 compared to the \$31.34 per day the state pays for each person serving a felony sentence in a county jail (the state also pays medical costs).<sup>151</sup> Even though the practice compounds overcrowding in local jails, counties may also seek out the revenues associated with housing state prisoners.

Counties are responsible for maintaining their jails and paying costs including medical expenses associated with incarcerating individuals awaiting trial and serving sentences for misdemeanor convictions.<sup>152</sup> With an increasing number of people being held pretrial because they cannot afford bail, local jail costs have increased significantly. According to testimony presented by Secretary Tilley before a legislative committee, in 2016, 37,000 people assessed as a low or moderate risk were held before trial for an average of 109 days, at a cost of over \$100 million to local governments.<sup>153</sup>

One of the ways counties have tried to offset local costs is by holding more individuals who are in state custody. However, since the payments from the state for these individuals are less than the actual cost of incarcerating them, some local jails hold more people in the same amount of space, creating overcrowding. The Kentucky Jailers Association testified in 2018 that their rate of reimbursement from the state does not cover the actual costs of incarcerating state prisoners and has not increased since 2005. They requested an increase of \$1 a day, which they did not receive. Some counties have addressed the issue by building very large new jails, with payment of the associated debt contingent on continuing to hold a large number of people in state and in some cases federal custody. In other words, counties are essentially locked into harmful practices that keep incarceration high in order to pay for the debt they have incurred.<sup>154</sup> The Kentucky Jailers Association also testified in 2018 that if the state re-opened any more private prisons, it would mean a \$28 million loss to counties. From their perspective, it was preferable to send individuals in state custody to local jails, even as the majority of jails were already overcrowded.<sup>155</sup> In response to this testimony, the final budget included funding for just one private prison that was already opening.

In addition to the quiet local jail expansion happening across the state and severe overcrowding in local jails, the complicated fiscal situation has also resulted in opposition from jailers and others in county government to needed justice reforms. Raising the felony theft threshold so that fewer low-level crimes get outsized punishments, for instance, would result in fewer felony sentences paid for by the state and more misdemeanor sentences paid for by the counties.

Practices including low rates of pretrial release are driving jail overcrowding and leading to deplorable living conditions for many people, as was documented at length in the *Lexington Herald-Leader* investigative reporting series “Caged.”<sup>156</sup>

## COMMUNITY HEALTH AND WELL-BEING COMPROMISED BY HIGH RATES OF INCARCERATION

The long- and short-term harmful impacts of mass incarceration on the health and well-being of our citizens and communities are devastating. By continuing to enact policies that lead to more incarceration and involvement with the criminal justice system, a growing share of state resources are funneled into our very expensive correctional system. More of these resources should go instead toward investments in meaningful and much less costly front-end services such as substance use disorder treatment that in the end would help keep more Kentuckians out of jail and prison, while improving the overall health of communities.

As a result of being currently or previously incarcerated, Kentuckians and their families experience many of the factors that research shows lead to poor health outcomes, including income instability, limited access to health care and barriers to quality housing.<sup>157</sup> Imprisonment is associated with a shorter life expectancy, higher rate of infant mortality, and numerous other negative impacts on the health of families and communities.<sup>158</sup> Because people of color are unjustly overrepresented in our system, they are disproportionately affected by the negative health outcomes associated with incarceration.<sup>159</sup>

The future of Kentucky children is also at stake. Children with incarcerated parents struggle more in school, have poorer health outcomes and fewer economic opportunities.<sup>160</sup> Given Kentucky has the second-largest share of children with a parent who has been incarcerated in the nation, the stakes for children and families are high.<sup>161</sup>

## BUDGET CUTS STRAIN JUSTICE SYSTEM

Most areas of the state's justice system continue to operate under severely depleted budgets, jeopardizing public safety, access to legal representation for low-income Kentuckians and the continuation of successful programs that save the state money in the long run. The 2018–2020 budget included modest but critical investments in several areas—such as new vehicles for state police and for hiring additional public defenders and prosecutors to bring down caseloads—but these were not enough to support the system's efficiency and effectiveness.

## CORRECTIONS

Corrections costs continue to rise due to a growing number of state prisoners, staffing shortages due to low pay that result in overtime for current staff, and increasing medical services costs. For example, the Department of Corrections spends approximately \$13 million a year for overtime and travel costs due to an inability to fill jobs in the LaGrange prison in Oldham County, a situation that exists primarily due to low pay compared to other jobs

in the area. In addition, as a result of low salaries and difficult working conditions, 65% of the state's correctional security staff has less than 5 years of experience.<sup>162</sup>

Probation and parole officers received a modest raise this biennium due to a change in the state salary scale, which had not been adjusted for 12 years (these have also been very high turnover positions).<sup>163</sup> However, caseloads remain too high. There are 575 officers to manage the more than 48,000 people on supervision.<sup>164</sup>

## STATE POLICE

The state police were protected from 2018–2020 budget cuts, enabling them to remain at “survival level funding,” according to the Secretary of the Justice Cabinet.<sup>165</sup> In 2018, state police were down to 838 troopers compared to a historic high point of over 1,000. The state police did receive some additional funding for needed vehicles in the 2018–2020 budget.<sup>166</sup> And an additional \$1 million a year was included in the budget for forensic laboratory technicians who work in crime labs and get paid at about half the rate of workers in surrounding states.<sup>167</sup> The crime lab impacts every criminal justice agency in Kentucky, but technicians' salaries were so low that turnover has been very high, undermining the lab's effectiveness.

According to recent testimony, wages for entry-level forensic biologists in Kentucky remain the lowest in the nation.<sup>168</sup> Due to continued staffing issues, the average amount of time to complete a sexual assault evidence kit in Kentucky is an appallingly high 262 days; There are currently 1,138 cases with pending kits.

## MEDICAL EXAMINER'S OFFICE

The Medical Examiner's Office plays an important role in law enforcement, the justice system, public health, understanding child fatalities and fighting drug epidemics. But inadequately funded and staffed offices struggle to meet these needs. In February 2018, the state's Chief Medical Examiner testified that limited funding through the state budget has resulted in reduced services.<sup>169</sup> Specifically, it is difficult to hire doctors due to low pay. And despite the increased workload due to more opioid-related deaths, there has been no funding for additional doctors. In fact, in order to meet the increased toxicology needs associated with drug-related deaths, the Medical Examiner's office takes on approximately \$300,000 to \$500,000 a year in debt.

## DEPARTMENT OF PUBLIC ADVOCACY

The 2018–2020 budget included some additional, badly-needed funds for the Department of Public Advocacy (DPA) to hire additional staff. Due to budget constraints, DPA was operating under a hiring freeze prior to the increase in funding, with only 518 staff when 552 were needed.<sup>170</sup> Kentucky DPA caseloads were significantly above national standards, compromising the ability of public defenders to provide adequate representation for their clients. In 2018, caseloads were 165% of the national standard.<sup>171</sup> While the increase in DPA funding in the 2018–2020 budget

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“Salaries for prosecutors and public defenders are so low, we are losing experienced attorneys every day and having a hard time filling our vacancies. While caseloads are still high, what defenders need most right now are salaries that make public defense a viable career, not just a temporary job experience.”

—Damon Preston, Kentucky's Public Advocate

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has helped with trial caseloads, they remain excessively high. Also, no additional funding was provided over the biennium for hiring needed support staff or to increase the very low salaries of, and reduce record-high turnover

for, DPA attorneys. A 2015 report found Kentucky's public defenders (and prosecutors) were paid 23% less than surrounding and comparative states.<sup>172</sup> Workloads are expected to increase with additional counsel being required for some parole revocations due to a court order.<sup>173</sup>

The 2018–2020 budget also funded 11 additional Alternative Sentencing Workers, who work with clients with substance use disorders or mental health disorders to provide sentencing alternatives to prison such as treatment services. This was an important investment and additional funds for this program in the upcoming budget would benefit many more individuals while saving the state money and keeping communities safe. The program is nationally recognized and every \$1 invested has been shown to save \$3 to \$6.<sup>174</sup>

## UNIFIED PROSECUTORIAL SYSTEM

Prosecutors have testified in recent years about how cumulative budget cuts since 2008 have led to strained services. The 2018–2020 budget included some modest additional funds to hire more prosecutors, but their salaries continue to be low compared to other states.<sup>175</sup> The budget also directed \$387,700 a year—the first time such funding was specifically directed for this purpose—to support the Rocket Docket Program. This program enables some individuals with drug-related charges to have their cases moved through the system quickly if they plead guilty (sometimes to a reduced charge) and enter treatment—avoiding long stays in jail.<sup>176</sup>

## JUDICIAL SYSTEM

Contingent upon available funds within the judicial branch, the 2018–2020 budget allowed for 2.5% salary increases each year for judges and elected court clerks.<sup>177</sup> But judicial salaries continue to be much lower than in most other states. Kentucky's circuit court judges make \$30,000 less than the national average, and Kentucky's Supreme Court justices make \$36,000 below the national average.<sup>178</sup> The judicial branch budget request for the 2020–2022 biennium includes a 2.5% raise each year for all elected and non-elected positions.<sup>179</sup>

The Administrative Office of the Courts runs the state's specialty courts (such as drug court) that provide alternatives to incarceration through participation in drug treatment and other aspects of the program. Unfortunately, the state's needs are much greater than what is available, and without additional staff for case management and support, the number of participants will have to remain inadequate at approximately 2,360 a year.<sup>180</sup> Chief Justice Minton has indicated the drug court model is not designed to support such a huge influx of people needing services due to the state's drug epidemic; however, the judicial system's budget request did not end up including a plan for addressing these considerable needs.<sup>181</sup>

## INADEQUATE FUNDING IN OTHER AREAS AFFECT A WIDE RANGE OF KENTUCKIANS

The cumulative budget cuts since 2008 have created serious fiscal strain in additional budget areas that impact Kentuckians across the state. The list below highlights some of the services that have been affected by state budget cuts. Note that cuts are calculated between 2008 and 2018, and then again for the current budget. This is because skyrocketing pension payments in recent years, which are included in the budget documents, distort the comparison.

- The budgets for the State Auditor, Attorney General and Secretary of State were cut by an inflation-adjusted 29% to 35% between 2008 and 2018, and were cut yet again in the 2018–2020 budget by 6.25%.

These cuts impact the state's ability to protect consumers, oversee fair elections and monitor how public dollars are spent.

- Funding reductions to the Energy and Environment Cabinet of an inflation-adjusted 27% between 2008 and 2018 jeopardize the state's ability to respond to emergencies, monitor and identify air, hazardous waste and solid waste infractions, and prevent crises from developing. Water quality has already suffered due to reduced capacity for environmental enforcement resulting from budget cuts.<sup>182</sup> A study found that in 2015, Kentucky had the largest share in the nation of its population getting water from utilities with at least 1 federal safety regulation violation (53%).<sup>183</sup> The Cabinet was cut another 6.25% in the 2018–2020 budget.
- Repeated lapses to the General Fund of revenues generated by the Public Service Commission, which regulates most utilities in Kentucky including water districts, for the specific purpose of providing the resources necessary to effectively perform its regulatory duties, have only made the water quality situation worse. Funding available to the Commission has, according to one calculation, fallen by around 20% over the past 10 years and staffing levels have dropped by about 40% during this time period.<sup>184</sup> Kentucky's drinking water infrastructure needs are an estimated \$8.2 billion over the next 20 years according to the U.S. Environmental Protection Agency's 2015 needs survey.<sup>185</sup>
- After being slashed 46% in inflation-adjusted terms between 2008 and 2018, the Kentucky Arts Council was cut another 6.25%. Kentucky Educational Television (KET) was as well, on top of a 29% cut between 2008 and 2018.
- Before being cut an additional 6.25% in the 2018–2020 budget, the Commission for Children with Special Health Care Needs had already been cut by 16% since 2008.
- The Commission on Women received no funding in the 2018–2020 budget.

There are clear ties between many of these agencies and Kentuckians' ability to thrive. And more is at stake for some: For instance, since people with low incomes and people of color often live in areas with more air and water quality challenges, investing more in environmental protection can help remove barriers to health while also improving health equity in our state.<sup>186</sup>

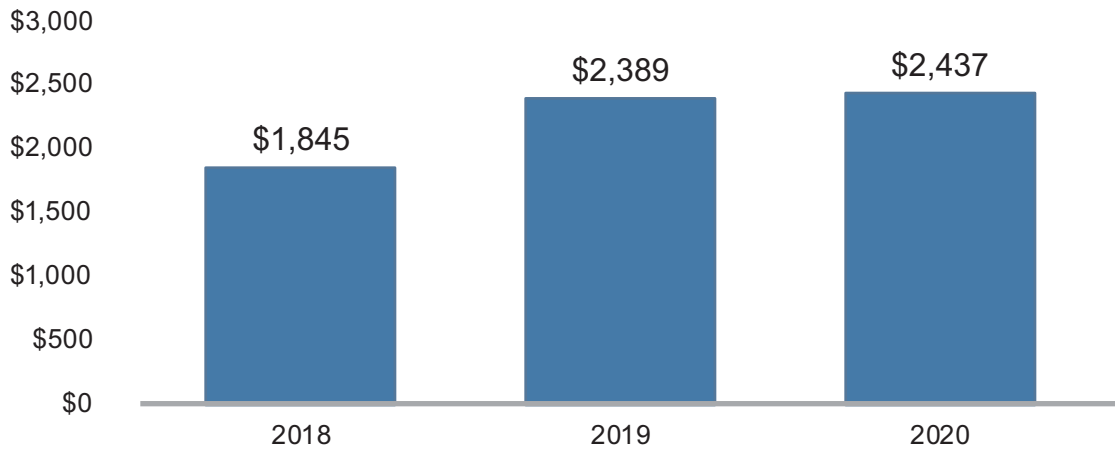
## WITH MORE ASSUMPTION CHANGES, KRS PENSION COSTS WILL RISE FURTHER

Last budget saw a massive increase in pension contributions, especially for the Kentucky Retirement System (KRS) state plans. Those increases were due primarily to sudden assumption changes made by the KRS board in 2017 that dropped the payroll growth and investment return assumptions to the most cautious in the country. As a result, the employer contribution rate for the Kentucky Employees Retirement System (KERS) non-hazardous plan spiked from 49% of employees' pay to 83% in a single year.

Along with small increases in the contribution to the Teachers' Retirement System, the state paid approximately \$540 million more (from all sources) to the state plans in 2019 than it did in 2018, then maintained approximately that level in 2020.

## Pension Costs Have Been Rising

Employer contributions to state pension systems  
(in millions)



Source: KCEP estimates based on analysis of data from TRS, KERS, SPRS, JFRS, OSBD. Funding is from all sources, not just General Fund. Includes pension portion only, not retiree health.

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The systems are requesting additional increases in the next two-year budget. As in the past, the biggest issue by far remains the severely underfunded Kentucky Employees Retirement System (KERS) non-hazardous plan. Increased contributions to that plan since 2014 have finally stabilized its condition; The plan's funded ratio rose from 12.9% in 2018 to 13.4% in 2019 and assets are finally growing again after years of being depleted. However, the contribution rate for the plan will still go up next year, rising from 83% of pay to 93%. That added cost will be hefty—the cost equivalent to giving most all employees a 10% raise.

Costs continue to rise for a few main reasons. First, the KRS board made a change in the mortality assumption (how long workers are expected to live) that adds cost. Second, payroll of active workers in the plan continues to decline as employers in the plan facing budget cuts reduce staff size, outsource work to private contractors and keep salaries frozen. Because pension contribution rates are currently set as a percent of employers' payroll, they incentivize employers to reduce employment. There will be discussion of changing that system to a method based on fixed-dollar contributions in the coming session.

A third reason and an issue moving forward for the budget relates to quasi-governmental organizations in the KERS non-hazardous plan, including health departments, regional universities, community mental health centers, domestic violence agencies and others. For the last two years, contributions from these organizations ("quasis") were frozen at 49% of pay rather than 83% because they could not afford the higher payments. That means the retirement system was not receiving full actuarially determined contributions. The future of quasis in the pension system was put in doubt due to House Bill 1 that passed in a special session in the summer of 2019. That bill incentivized quasi-governmental organizations to leave the pension system by offering them a lower payment plan if they immediately freeze the benefits of approximately 9,000 current employees. Mid- and even late-career employees would lose most of their pensions from such a freeze, and doing so may be at odds with the inviolable

contract. These terms also pass costs in the future onto the severely already-underfunded KERS non-hazardous plan and weaken it further by taking new employees out of the plan.<sup>187</sup>

HB 1 gives the quasi-governmental organizations until May 1, 2020 to decide whether to stay in the retirement system or take one of four exit options, which include paying the liability as a lump sum or in installments and freezing or not freezing the pensions of current employees. Some of the quasis have indicated they would like to stay in the existing pension plan and/or protect the pensions of current employees, but need additional funding. If many quasis leave the system, it creates added costs for the pension plan in the future that will also require additional revenue to address.

The Teachers' Retirement System (TRS) continued to show improvement over the last year, with its funded ratio ticking up from 57.7% to 58.1%.<sup>188</sup> That's the third consecutive year the funded ratio has improved thanks to the state resuming full actuarial funding to the plan in 2017. The contribution rate to that plan will be very close to the level in the last budget. One area of need will be in the state's contribution for the medical insurance of retired teachers under the age of 65. In 2020, the state did not make that \$70 million contribution in the budget, as has been the practice, and instead charged the TRS medical fund with picking up the cost. The budget included a provision, however, that if the state had a surplus at the end of FY19, then those dollars could go toward that expense. Since that surplus materialized, the medical fund was not left on the hook. However, putting that \$70 million back into the new budget for two years will be an added cost.

## OTHER COSTS IN NEXT BUDGET

On top of the funding needs created by previous budget cuts and significant budgetary pressure stemming from increased pension contributions, Kentucky faces additional, but routine costs in the 2020–2022 biennium that will be difficult to cover.

### ROUTINE COST INCREASES

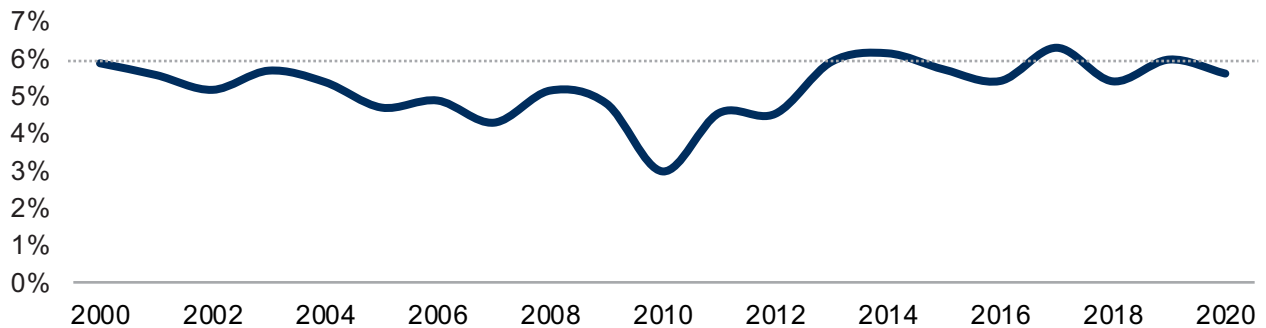
The state budget must account for inflation. According to the U.S. Bureau of Economic Analysis (BEA), basic inflation for state and local governments' costs increased 3.7% between 2017 and 2018 compared to 2.4% for the rest of the economy.<sup>189</sup>

### DEBT SERVICE COSTS

The 2018–2020 budget included \$973 million in debt, with \$370 million in General Fund-supported debt for capital projects and the remainder in agency funds, which is less than what was bonded in the previous biennium. To reduce immediate budget costs at the time, the state restructured some of its debt between 2009 and 2012, pushing debt forward to future years—which costs more in the long run. As a result, appropriation-supported debt service as a share of total revenue rose through 2014 and somewhat stabilized thereafter. It was lower at an estimated 5.6% in 2020 than it was in 2019 at 6%, but remains elevated compared to past years. The General Assembly strives to meet a best practice that debt service costs not exceed six percent of total revenue.<sup>190</sup>

## Debt Service As a Share of State Revenue Remains Elevated, But Currently Below Standard

Appropriation supported debt service as a percent of total revenue: debt capacity ratio



Source: Commonwealth of Kentucky 2018–2020 Budget of the Commonwealth: Budget in Brief.

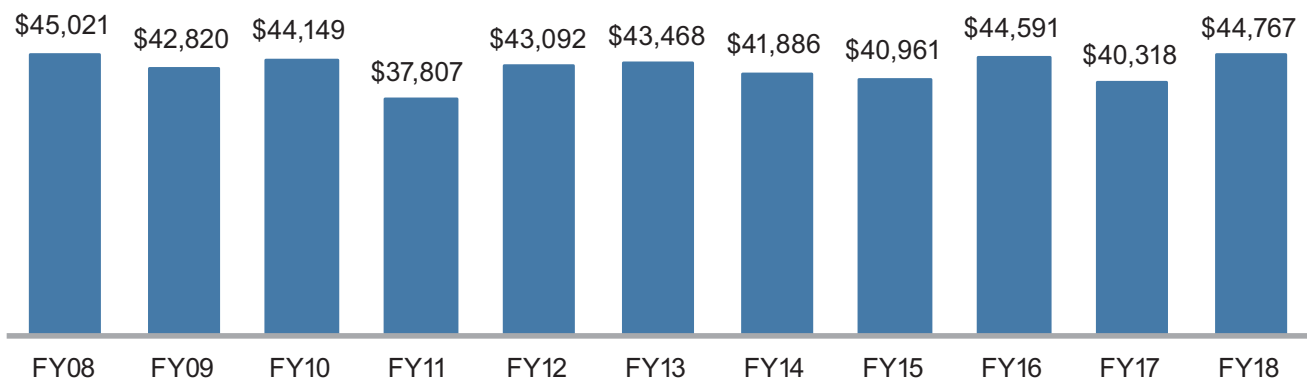
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## STATE SALARIES

Though there have been ad-hoc raises within certain departments to do things like increase retention among social workers or address shortages in the police force, there has not been a meaningful, across-the-board salary adjustment for state workers in 8 of the last 10 years.<sup>191</sup> According to the Personnel Cabinet, 42,270 state employees worked in FY18 with an average salary of \$44,767.<sup>192</sup> This is not only relatively stagnant for state salaries, it is also below the average private salary (\$46,189), and well below what is needed for a modest but secure family livelihood in Kentucky (\$68,238 for a family of 4 in Franklin County, for example).<sup>193</sup> Adjusted for inflation, state workers earned less in 2018 than they did in 2008.

## State Salaries Have Been Stagnant for a Decade

Average annual gross salary CPI-U inflation-adjusted to 2018 dollars



Source: KCEP analysis of Kentucky Personnel Cabinet Annual Reports data and BLS inflation measures.

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## PART II: REVENUE

### REVENUE INSUFFICIENT TO MEET BUDGET NEEDS

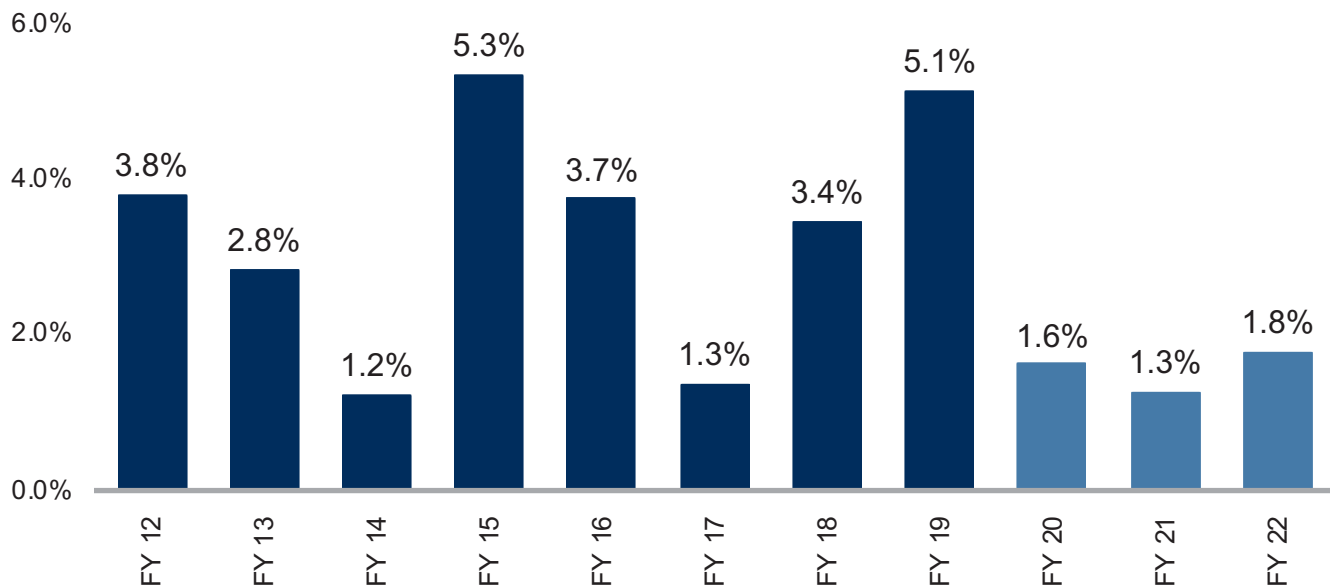
The second half of this report discusses the revenue the state expects to collect over the 2020-2022 biennium and how far it will go to meet budget needs described in the first half of the report.

The General Assembly passed significant changes to the tax code in both 2018 and 2019 that have made estimating revenues difficult for the next few years. However, revenue growth is expected to be weak.<sup>194</sup>

Estimates for the 2020-2022 biennium anticipate growth of just 1.3% in 2021 and 1.8% in 2022, producing \$146 million in new revenues in 2021 and \$207 million in 2022. Compared to budget needs, as well as historical annual growth in the total General Fund, growth in the next biennium is expected to be slow.

#### Revenue Growth Expected to Be Tepid Over Biennium

Historical and projected annual total General Fund growth



Source: OSBD.

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The performance of individual revenue streams will be discussed at length later in the report, but some of the factors shaping the revenue forecast include: significant reductions in corporate and income tax revenues due to a possibly slowing economy and the 2018 and 2019 tax changes, a decline of more than 2% in cigarette tax receipts in each year of the biennium, and a leveling off of growth resulting from the expansion of the sales tax base in 2018.

Kentucky ended FY19 with \$195 million more in revenue collections than were expected based on the revenue estimate—a 1.7% increase compared to the official projection. These unanticipated revenues do not allay concerns about structural shortcomings of the revenue system to meet budget needs. Rather, weak growth in the next couple of years reflects the fact that revenues comprising the unanticipated receipts in 2019 are not expected to recur. Receipts in 2019 above those anticipated included a significant amount of one-time monies from the sale of abandoned property securities, the cigarette floor stock tax, and more revenue than expected from a 2018 cigarette tax increase that is not anticipated to continue. After payment of Necessary Government Expenses (NGEs), distribution of dedicated revenues and other minor adjustments, the General Fund surplus balance was \$130 million, which, pursuant to the surplus expenditure plan included in the 2018–2020 budget, was distributed \$70 million to the TRS medical insurance fund, and \$60 million to the Kentucky Retirement System nonhazardous unfunded pension liability fund.<sup>195</sup>

The budget challenges described in the first part of this report—successive rounds of budget cuts due to insufficient revenues for many years—cannot be addressed with the modest new General Fund revenues predicted over the coming biennium. Expected new revenues are small compared to the structural deficit Kentucky has accumulated over the years, the pension liabilities the state owes and the strains being experienced in a variety of services. In fact, the gap between the recurring revenue Kentucky generates and what it will take to get the budget back on track is likely to continue to grow through the next biennium and into the future. This situation was made worse by the significant tax changes enacted in 2018 and 2019 that shift reliance from revenues generated by the individual income tax, which has historically been the best performing tax and better tracks growth in the economy, to the sales tax, which grows more slowly, and the cigarette tax which is expected to decline.

## KENTUCKY FACES A LARGE STRUCTURAL DEFICIT

Kentucky has a well-documented, persistent and growing structural deficit—which means recurring revenues do not match recurring expenditures. As a result of tax breaks growing in size and number, Kentucky was recognized by Pew for the third time in three years as one of only 10 states that continues to fall short in meeting the budgetary needs of the commonwealth with existing revenues.<sup>196</sup>

As the first part of this report describes, one of the ways the budget has been balanced despite the structural deficit is through multiple rounds of budget cuts. Other appropriation-side accommodations have included underfunding pensions, shifting education expenses to local school districts and shifting the cost of providing public goods to local governments.

On the revenue side, legislators have addressed the lack of resources by using fund transfers, authorizing expenses as “Necessary Government Expenses” (NGEs), and letting the state’s rainy day fund become inadvisably low. The General Assembly also enacted changes to the tax code in 2018 that resulted in a short-term bump in revenues to help balance the 2018–2020 budget that will be almost entirely gone by 2024 due to new or expanded tax breaks enacted in 2019 for corporations and other special interests, as well as components of the 2018 tax changes that weaken revenue growth over time.

## FUND TRANSFERS, LAPSES AND BEGINNING BALANCES

Using “one-time” resources to balance the budget means applying non-recurring revenues to recurring expenses. These resources include fund transfers, lapses and beginning balances. These monies will have to be replaced in the new budget, or additional budget cuts will result.

In the 2018–2020 budget, the General Assembly transferred or lapsed a total of \$604 million from various agency-restricted funds or appropriations to the General Fund over the biennium—often from accounts that receive revenues for a specific statutory purpose. They include:

- \$311 million from the Public Employee Health Insurance Trust Fund from amounts that have accrued because employees have paid in more than has been paid out in claims and other expenses,<sup>197</sup>
- \$150 million from the Permanent Pension Fund initially deposited in 2016,
- \$23 million from the Petroleum Storage Tank Environmental Assurance Fund,
- \$15 million from other agencies that are part of the Energy and Environment Cabinet,
- \$46 million from agencies that are part of the Public Protection Cabinet,
- \$15.2 million lapsed from the Judicial Branch,
- \$13.8 million transferred from the Transportation Cabinet,
- \$5.6 million from the Commonwealth Office of Technology,
- \$4 million from a volunteer fire department loan fund,
- \$4.5 million lapsed from the Legislative Branch,
- \$13 million lapsed from the Public Service Commission, and
- \$4 million lapsed from Tobacco Fund debt service.<sup>198</sup>

## NECESSARY GOVERNMENT EXPENSES

Traditionally, NGEs have been used to authorize unanticipated expenditures beyond amounts appropriated for things like emergencies and fire suppression that cannot be easily predicted. Identifying an expense as an NGE after the fact permits expenditures not anticipated and included in the “bottom line” amount appropriated in the budget bill. This method allows the General Assembly to pass a budget that actually authorizes General Fund expenditures exceeding total General Fund revenues.

Over several recent budget cycles, the General Assembly has included known recurring expenses as NGEs. In FY19, NGEs were \$81 million.<sup>199</sup> This practice shifted in the 2018–2020 budget, which included increased appropriations totaling \$70 million in FY19 and \$74 million in 2020 for recurring expenditures that have been paid for as NGEs in the past. As a result, NGEs fell to \$33 million in FY19.<sup>200</sup>

Although NGEs were significantly lower in FY19, corrections and guardian ad litem fees (for court-appointed attorneys representing minors) continued to be significant in 2019 with corrections accounting for \$14.9 million of the total NGEs, and guardian ad litem fees accounting for \$9 million. In both of these areas, anticipated growth in costs, related in part to our state’s high rate of incarceration, could be factored into the appropriations process.

Without criminal justice reform and additional resources to address substance use disorders in Kentucky, these expenses will not go away.

## BUDGET RESERVE TRUST FUND

The purpose of the Budget Reserve Trust Fund (BRTF) or “rainy day fund” is to have resources on hand for unanticipated expenses and to provide funds if revenues are less than projected. Preparing for the next recession by saving money during economic expansions is therefore a primary purpose; in fact, credit rating agencies may downgrade states that spend down their rainy day fund during expansions.<sup>201</sup> Yet because Kentucky is unable to pay for recurring expenses with recurring revenues, the rainy day fund has been used in this manner.

At the end of 2018, Kentucky was one of just a handful of states that has not significantly increased rainy day fund savings.<sup>202</sup> The balance of the BRTF at the beginning of FY 2019 was \$94 million—just 0.9% of the General Fund and far less than the state’s 5% target. The BRTF balance at the close of FY 2020 is projected to be \$306 million after a budgeted transfer of \$195 million, reduced by the impact of tax expenditures enacted during the 2019 session of \$18.1 million. This appropriation will bring the balance up to 2.7% of the General Fund—still well below the target.<sup>203</sup>

## A MINIMAL ESTIMATE OF KENTUCKY’S STRUCTURAL DEFICIT

To illustrate the magnitude of the problem facing the General Assembly in crafting the 2020-2022 budget, the table below adds together one-time transfers and lapses used to balance the 2020 budget. To simply maintain current investment levels—which, as the first half of this report demonstrates, are far below adequate—the next budget will likely also have to identify and rely heavily on one-time resources.

### New Budget Starting Out with Big Hole

One-time monies used to balance 2020 budget

	Amount
Fund Transfers (Restricted fund and Transportation Cabinet)	\$ 308,288,500
Lapse from Tobacco Debt Service	\$ 1,987,500
Lapses from Legislative and Judicial Branches	\$ 9,769,000
Public Service Commission Lapse	\$ 6,485,200
<b>Total</b>	<b>\$ 326,530,200</b>

Source: Enacted 2018–2020 Budget of the Commonwealth.

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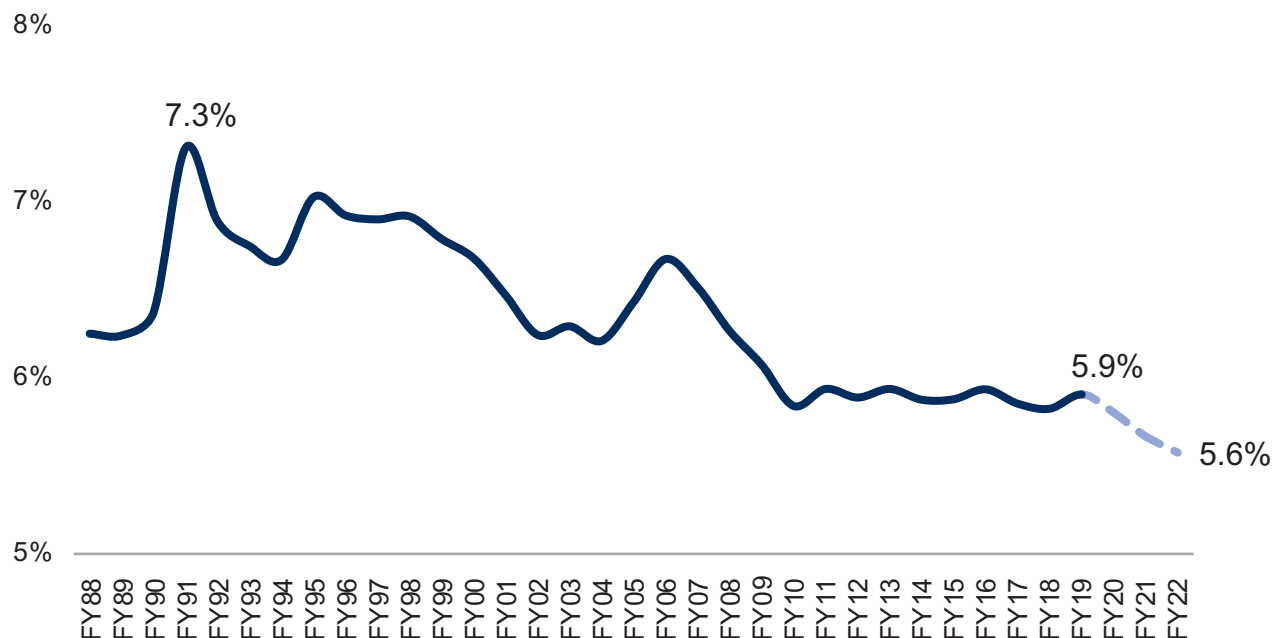
In other words, our budget “hole” starting out the next fiscal year is at least \$326 million.<sup>204</sup> Projected new revenues for FY 2021 are \$146 million, leaving a negative balance of \$180 million without including any routine cost increases, new agency budget needs, emergencies or the amount needed to fully fund pension obligations—though modest new revenues now anticipated in 2020 may somewhat reduce that number.

# GENERAL FUND REVENUE ERODING AS A SHARE OF KENTUCKY'S ECONOMY

Revenue that is consistently inadequate to meet budget needs is the result of tax policy choices. Due to the legislature's regular passage of new tax breaks as well as the growing impact of existing tax exemptions, revenue is actually eroding relative to the size of our economy. Kentucky's General Fund as a share of total personal income has been shrinking and will continue to do so through 2022, making it increasingly difficult to fund basic services. The graph below shows that General Fund revenue will shrink from 5.9% of personal income in 2019 to 5.6% in 2022. Though a seemingly minor drop, 0.3 percentage points in a \$214 billion economy equals \$706 million not being collected by the end of the biennium.

## Forecast Shows Continued Erosion in the General Fund

Total General Fund Revenue as a share of Kentucky Personal Income, historical and projected



Source: KCEP analysis of data from OSBD, BEA.

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As illustrated, erosion in General Fund revenues is a long-term trend. In 1990, under a Kentucky Supreme Court order requiring adequate and equitable funding of public schools in the commonwealth, the General Assembly enacted revenue-raising tax reform as part of KERA. State-level tax changes included (in order of how much revenue they generated) eliminating several individual income tax deductions, increasing the sales tax rate from 5% to 6% and increasing corporate income tax rates. Since then, the tax code has been amended many times and in almost all cases, rates have been reduced and tax breaks have been added or expanded, so that the ground gained in 1991 has been lost—and then some. If Kentucky's General Fund had simply kept up with the economy since 1991, in 2020 legislators would have \$3.1 billion more to invest through the budget.<sup>205</sup>

What this disconnect between Kentucky’s tax system and growth in the economy means is that regardless of the level of economic growth (discussed in the next section), relative General Fund performance will continue to decline.

TAX BREAKS GROWING DUE TO LEGISLATIVE ACTION

Every other year before a budget session, the Office of the State Budget Director (OSBD) publishes a tax break report—known as the tax expenditure analysis—that provides insight into Kentucky’s growing revenue hole. The analysis for the 2020-2022 biennium estimated that tax breaks would drain \$8.2 billion from the General Fund in FY 2021 and \$8.5 billion in 2022. This huge amount excludes entire categories of tax breaks, costing billions more, that should have been counted in the total and were included in prior tax expenditure analyses.<sup>206</sup>

This list of tax expenditures grows and becomes more costly as consecutive General Assemblies pass new, or expand existing, tax breaks. Many of these are described as “economic development incentives” rather than “tax breaks,” but the legislation establishing them lacks reporting and oversight requirements needed to evaluate their economic return. Independent analysis suggests many such tax breaks are not cost-effective, and in many cases, the incentives actually cost more than the benefit, especially when compared with traditional direct budget investments in an educated workforce through preschool, K-12 education and college affordability.<sup>207</sup> The table below shows just a few of the new tax breaks passed in recent years.

**Tax Breaks Add Up Quickly**

Select tax expenditures added in recent legislative sessions

Year	Tax Break	Annual Cost
2019	Repeal of the Bank Franchise Tax moving banks to the income tax	\$56 million
2019	Property tax reduction for heavy equipment leasing companies	\$4 million
2019	Alternative apportionment for certain communications services	\$40 million
2019	Accelerated expensing of capital purchases	\$33 million
2018	Inventory tax credit for corporations phasing in over 4 years (annual cost reflects full phase in, FY 2022)	\$155 million
2018	Transfer of TVA PILOT payments to Western KY ED entities	\$6 million
2017	Expanded aviation fuel tax credit for Amazon	\$3 million
2016	Extended UPS Metropolitan Tax Credit for 10 years	\$4 million
2014/15	Expanded film industry credit	\$41 million

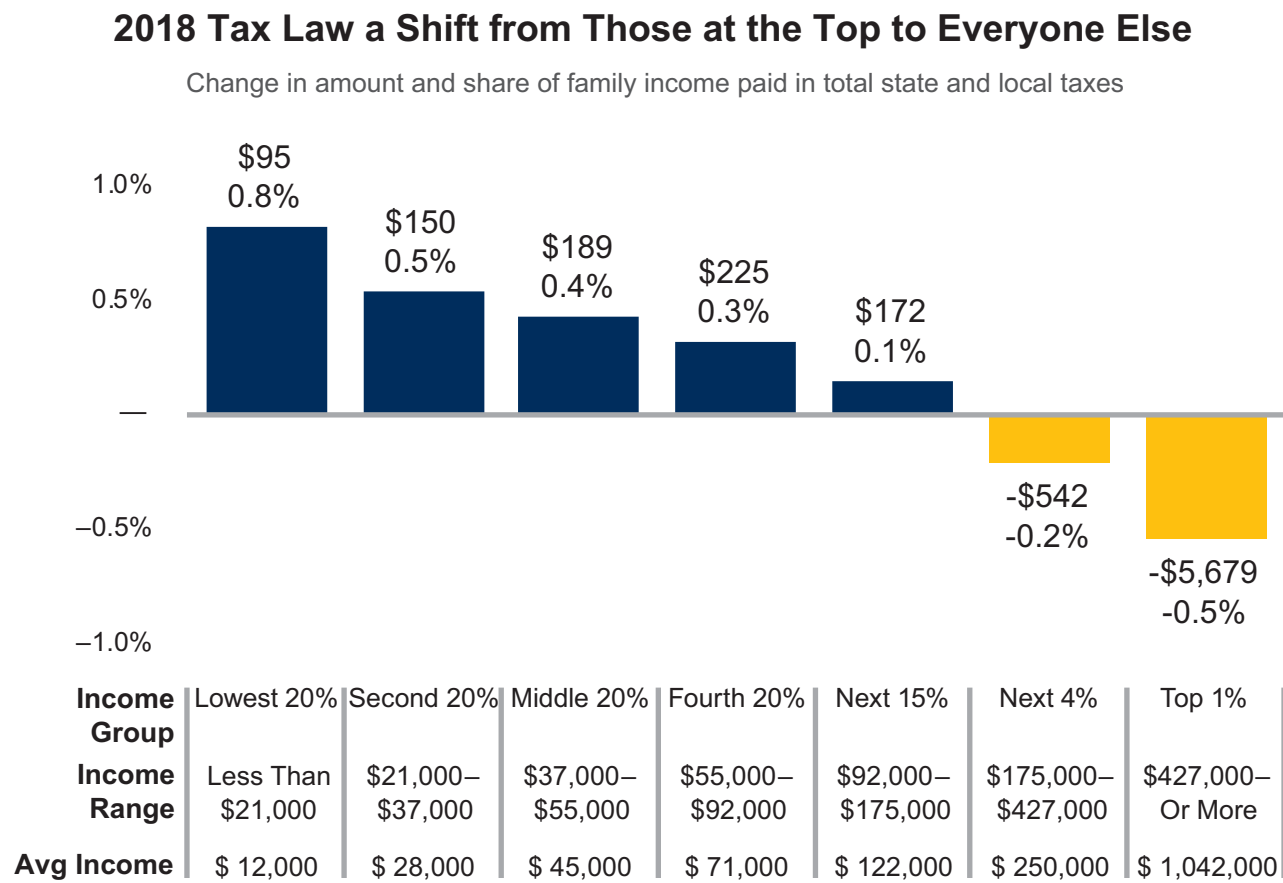
Source: Tax Expenditure Analysis 2020–2022, OSBD.

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RECENT LARGE TAX BREAKS WEAKEN REVENUE GROWTH

In 2018, legislators flattened the progressive structure of our income tax and reduced the top income tax rate from 6% to 5% for individuals and corporations—an extremely expensive tax cut that provides the biggest break to wealthy Kentuckians. Other tax changes included in the 2018 package offset these revenue losses in the short term by expanding the sales tax base, increasing the cigarette tax rate and repealing several income tax

deductions and credits—changes that ask more of people with lower incomes. Revenue from base-broadening could have been used to shore up the General Fund and restore some of the past funding cuts. Instead, more than half of the new revenue was spent on tax breaks for the wealthy, with the net distributional impact of these changes being “upside-down;” they cut taxes for people with incomes in the top 5% but increased them on average for everyone else.



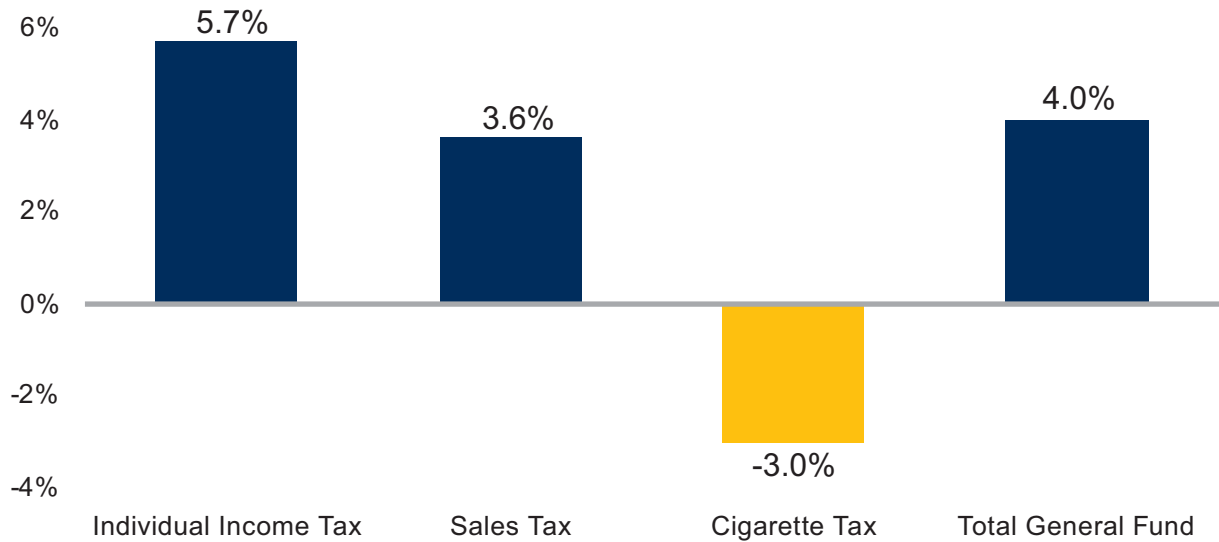
Source: Institute on Taxation and Economic Policy (ITEP).

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From a revenue standpoint, the 2018 tax changes resulted in a \$192 million bump in revenues for the General Fund in FY19. Going forward, the revenue impact will become increasingly negative because the changes constituted a shift toward slower-growing consumption taxes and a move away from more productive income taxes. Historical performance of the General Fund (see graph below) shows that growth in the individual income tax revenue has outpaced sales tax revenue, making a shift from the former to the latter a harm to the General Fund over time. Especially since the plan relied on a tobacco tax increase for approximately half the net new revenue, Kentucky will not be able to sustain the added revenue as consumption of tobacco products continues to decrease.

## Income Tax Strongest Revenue Source Kentucky Has

Average annual growth, FY 2010–2018



Source: KCEP analysis of OSBD data.

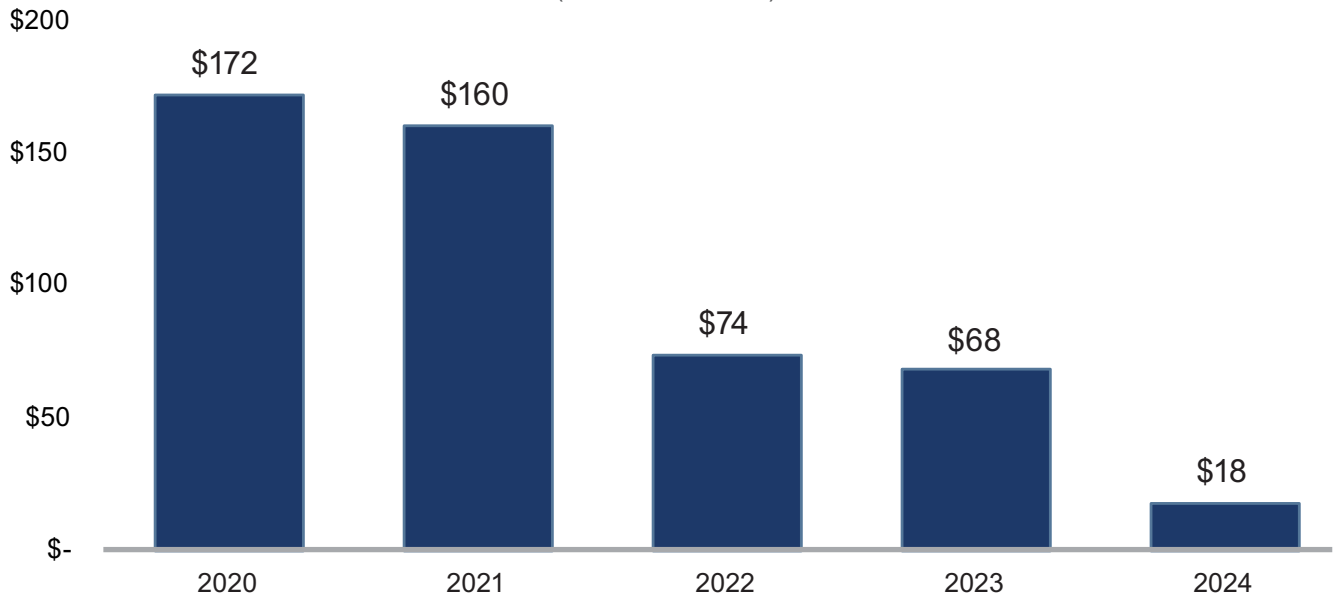
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In an economy where most income growth is at the top, corporations are experiencing record profits, and low- and middle-income families are seeing little if any wage growth, it is predictable that taxing wealthy people less while taxing people with low and middle-incomes more will result in slower revenue growth. This shift also exacerbates income and racial inequality by widening after-tax disparities. Kentucky now ranks 25th worst among the states on the Institute on Taxation and Economic Policy's (ITEP) inequality index, which measures the effect of state tax systems on income inequality. Without the 2018 changes, Kentucky would have ranked 34th.<sup>208</sup>

In 2019, the General Assembly enacted additional tax changes, adding more than \$110 million in new tax breaks for special interests including banks and large, multinational corporations—breaks which will grow over just a few years to consume almost all of the new revenues generated from the 2018 tax changes.<sup>209</sup> By 2024, all but \$17.8 million of the \$192 million in net new revenue Kentucky gained from raising taxes in 2018 will be spent on special interest tax breaks.<sup>210</sup>

## Revenue from Recent Tax Changes Drying Up

Net revenue from tax changes in 2018 & 2020 for fiscal years 2020–2024  
(millions of dollars)



Source: OSBD.

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Claims that these tax changes will make Kentucky more “competitive” and generate more revenue by attracting businesses and individuals to Kentucky are unfounded, and have been disproved by experiments in numerous other states including Kansas, North Carolina, Ohio and Louisiana.<sup>211</sup> State business taxes are a very small part of the cost of doing business, and matter little in business location decisions. Few individuals migrate and those who do so base those decisions overwhelmingly on job opportunities, family considerations or climate and not income or other taxes.<sup>212</sup> Meanwhile, individual and business income tax cuts undermine revenue growth, leading to more cuts in the public investments like education and infrastructure that are the building blocks of a strong economy and, as research shows, a healthy population.<sup>213</sup>

## TAX BREAKS ARE GROWING DUE TO CHANGING ECONOMY, STATE

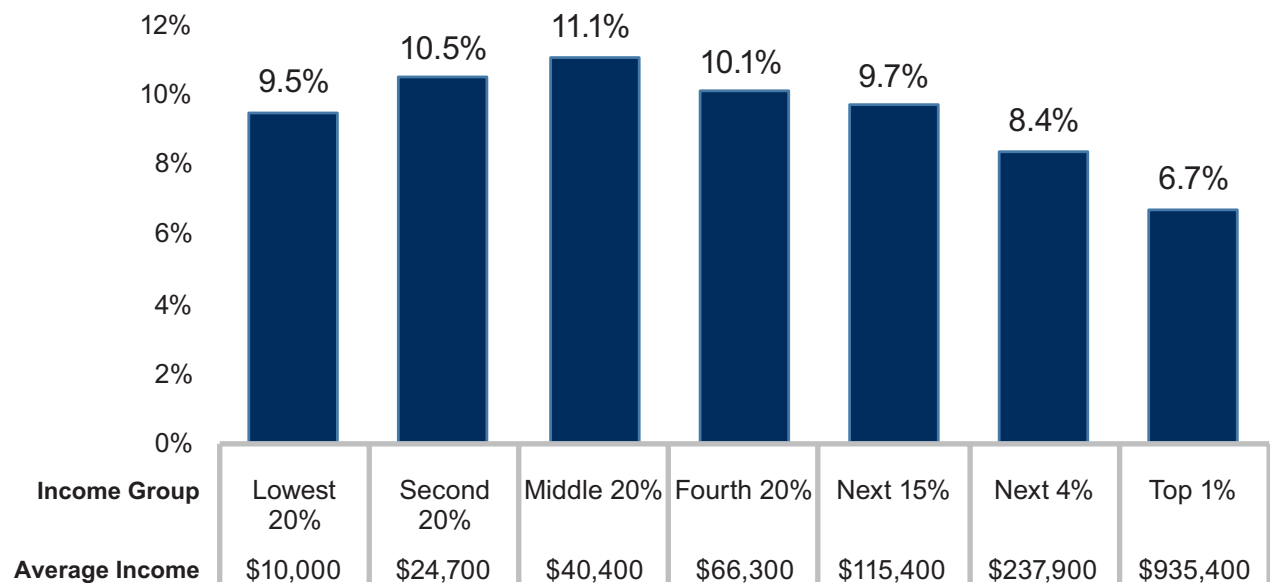
Another reason for erosion in the General Fund is that existing tax breaks are growing in size due to the changing nature of our state and our economy. For example:

- In 1995, the General Assembly exempted the first \$35,000 in private retirement income from taxation, an amount that grew to \$41,110 by 2007 when the General Assembly froze the growth. The General Assembly reduced the exemption amount to \$31,110 as part of the 2018 tax changes, but the exemption still remains one of the most generous in the United States. As Kentucky’s population ages, baby boomers retire and retirement income as a share of all income continues to grow, the impact of the tax break will grow, too.<sup>214</sup> Between 2006 and 2017, the number of federal tax returns filed by Kentuckians claiming retirement income increased by 25%, and the total amount of retirement income reported increased by 66%. Retirement income as a share of total adjusted gross income reported on Kentuckians’ federal tax returns increased from 9% to 11%.<sup>215</sup> The share of Kentucky residents over age 65 is forecast to rise from 15% to 21% between 2015 and 2030.<sup>216</sup>

- In 1979, legislators passed a 4% cap on state property tax revenue growth from year to year that has pushed the state property tax rate down from 31.5 cents per \$100 in property valuation to 12.2 cents as the property tax base has grown. If property tax revenue had been allowed to grow with property values over the last 38 years, meaning the rate stayed the same, the state could expect to collect \$569 million more in 2021.<sup>217</sup>
- As income and wealth in the economy become increasingly concentrated at the top, preferential tax treatment for the wealthiest Kentuckians holds back revenue growth. Between 2009 and 2015 in Kentucky, real income grew for the top 1% by 23.2% while for the bottom 99%, it grew by only 7.2%, with the top 1% capturing 34.4% of the overall growth. In Kentucky, the average income of the top 1% is 18.4 times greater than the average income of everyone else.<sup>218</sup> Yet instead of paying their fair share in taxes on their vastly higher income, the wealthiest one percent of Kentuckians pay the least as a share of their income in total state and local taxes (see graph below).

## Kentucky's Tax System Asks the Least of the Wealthiest Residents

State and local taxes paid as a share of family income



Source: ITEP.

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Preferential tax treatment for wealthy Kentuckians occurs because of the many tax breaks that reduce the effective tax rate for this group. The Institute on Taxation and Economic Policy (ITEP) estimates the top 40% of Kentuckians receive 77% of the total value of the state's overly generous retirement income exclusion. And as income has soared for those at the top while stagnating for everyone else in recent decades, the reduced, flat tax rate of 5% enacted in 2018 does not recognize the resulting stratification; family income for Kentuckians in the top 1% starts at about \$411,001, but averages \$935,400.<sup>219</sup>

Policies resulting in racial redlining, educational disparities and employment discrimination, for instance, have created barriers to wealth accumulation and economic opportunity for black and Hispanic/Latino Kentuckians while giving an advantage to white Kentuckians. As a result, preferential tax treatment for wealthy Kentuckians deepens racial disparities. While only 39% of white Kentuckians are in the 2nd and 3rd income quintiles depicted above facing the highest effective tax rates of 10.5% and 11.1%, 47% of African Americans and 46% of Latinos in Kentucky pay these rates.<sup>220</sup> Conversely, 21% of white, 10% of African American and 17% of Latino Kentuckians are in the top 20% of all taxpayers—the group paying the lowest effective tax rates.

## ECONOMIC RECOVERY HAS LEFT MANY BEHIND, DAMPENING REVENUE GROWTH

Though the holes in Kentucky's tax code undermine General Fund growth regardless of economic strength, the state of the economy, especially the labor market, also impacts revenue. When more Kentuckians are employed at higher wages, General Fund revenues grow because more taxes are paid on those earnings and people can better afford to purchase taxable goods and services.

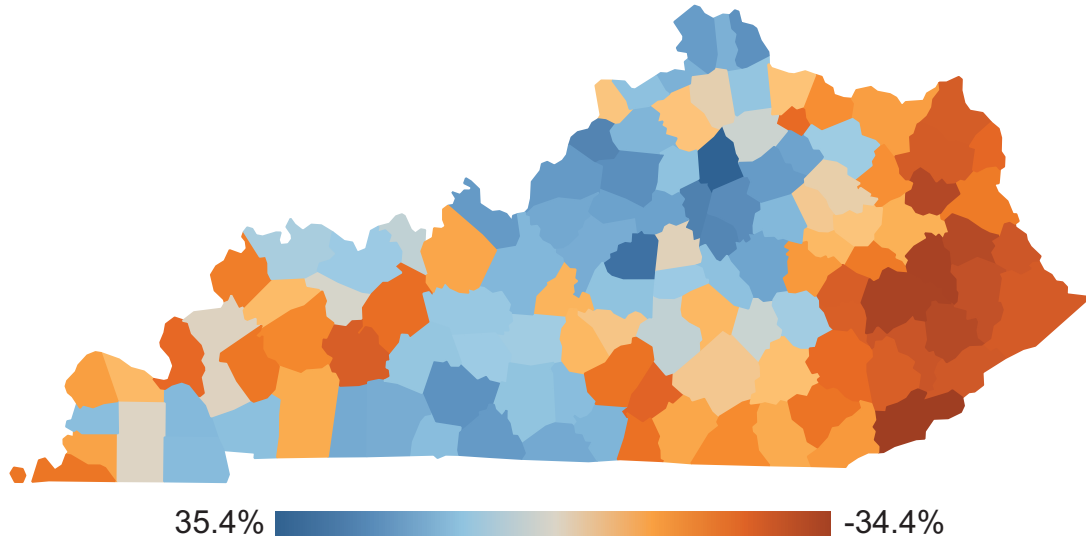
When wages for Kentuckians are weak and their budgets tight, however, revenue is dampened as well. The median, or typical hourly wage for Kentuckians in 2018 was \$17.09—about \$13,000 less than a single parent with one child would need to meet a basic family budget.<sup>221</sup> In recent years, wage growth has been non-existent; Adjusted for inflation, the median wage was \$17.19 in 2001. Kentucky's and the federal government's historically long failure to raise the minimum wage since 2009 has contributed to stagnating wages at the bottom and middle.

Furthermore, despite a low unemployment rate, many Kentuckians are without work. In September of 2019, Kentucky's unemployment rate was 4.4%—one percentage point less than it was in December 2007. But because job growth has not kept up with population growth since the recession, Kentucky actually faces a shortage of 29,000 jobs compared to employment levels in December 2007.<sup>222</sup>

With employment losses since the recession concentrated in rural Kentucky, especially in the eastern part of the state, local revenue collections are also weak. State fiscal challenges and budget cuts, which push responsibility for funding essential services onto local governments, only add to the difficulty many of these communities face in paying for school programs, public safety, libraries and more. And as federal, state and local budget cuts have led to reductions in governmental employment—which comprises a larger part of rural economies' total employment than metro economies'—the vicious cycle of declining revenue deepens.<sup>223</sup>

## Lopsided Recovery Continues to Leave Out Eastern Counties

Percent change in employment between August 2009 and 2019



Source: KCEP analysis of Local Area Unemployment Statistics.

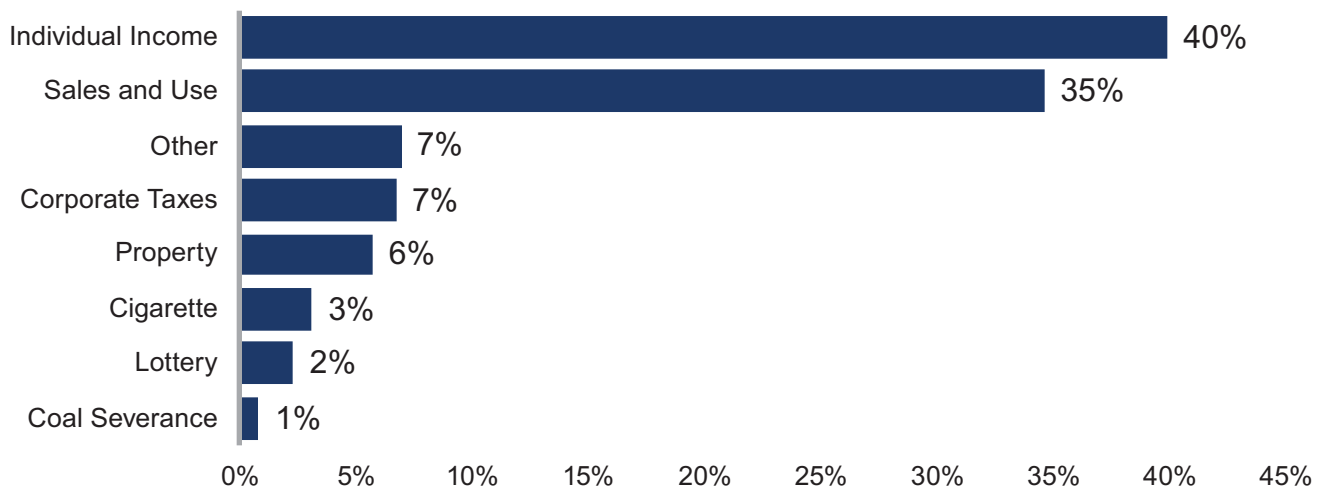
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## STRENGTHS AND WEAKNESSES OF INDIVIDUAL REVENUE STEAMS

The revenue forecast for the upcoming biennium recognizes continuing economic and structural challenges facing each of Kentucky's revenue sources. The section that follows examines historical and forecast performance for each major source of revenue, including the impact of particular tax breaks. The following chart shows how much each revenue source contributed to the total General Fund in FY 2019:

### Where Kentucky's Revenue Comes From

Revenue sources comprising, and their shares of, the General Fund



Source: OSBD.

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## INDIVIDUAL INCOME TAX

The individual income tax (IIT) has historically been Kentucky's largest, best-growing and most progressive (based on ability to pay) single source of revenue, generating \$4.6 billion in FY 2018 and accounting for 42% of the total General Fund. The 2018 tax bills made significant changes to the IIT, and as a result, receipts in FY 2019 were \$59 million less than receipts in FY 2018, reducing the overall contribution of the IIT to the General Fund to 40%.

In addition to the progressive rate structure being replaced by a 5% flat rate, significant changes made to the individual income tax in 2018 and 2019 include the following:

- Most itemized deductions were eliminated, including for taxes paid, premiums paid for health insurance coverage, premiums paid for long-term care insurance, casualty or theft losses, medical and dental care expenses, moving expenses and other miscellaneous expenses subject to the federal 2% floor.
- The pension income exclusion was reduced from \$41,110 to \$31,110, and
- The \$10 personal tax credit for taxpayers and dependents was eliminated.<sup>224</sup>

The repeal of the progressive rate structure in favor of a flat 5% rate resulted in an increased income tax burden for some Kentuckians of modest income, who benefitted from the prior lower rates between 2% and 4% on taxable income under \$5,000. It should be noted that people whose incomes are below the federal poverty level based on family size do not pay income tax in Kentucky, and those with incomes up to 133% of the federal poverty level pay at reduced levels, but these exclusions apply to only some low-income people.<sup>225</sup> Also, for some moderate and middle-income people, net IIT was increased because the repeal of most itemized deductions is outweighed by the small reduction in taxes due to the reduction/flattening of the rate. As a result of IIT changes in 2018, the bottom 80% of Kentuckians on average are paying a little bit more in income taxes (\$20-\$60), while those at the top—particularly the top 5%—are paying significantly less through the IIT; the average cut for the top 1% was \$5,998 and for the next 4%, \$756.<sup>226</sup>

Growth in the income tax has been stronger than that of other revenue sources over the long term. And while income taxes have been criticized as being volatile by those advocating a heavier reliance on consumption taxes, the nature of that volatility is an asset to the General Fund over time: Even though income taxes fell more precipitously during the Great Recession than sales taxes, they also recovered more sharply. In 2018, the last year before the major shift in reliance from the IIT to the sales and use tax, IIT receipts were up 4.8%, compared to an increase of 3.5% for the sales and use tax.

The CFG expects the IIT to grow 2.8% by the end of FY 2020. Over the next biennium, the CFG predicts 2.6% growth in 2021 and 2.7% growth in 2022. Nominally, the IIT is forecast to generate \$4.7 billion in 2020, \$4.8 billion in 2020 and \$4.9 billion in 2022.

Although most itemized deductions were eliminated as part of the 2018 tax changes, one large remaining exemption that primarily benefits moderately higher-income people is the home mortgage interest deduction. In 2020, this break is expected to carry a price tag of \$155 million. This deduction benefits homeowners over renters and can be used on up to two homes with larger deductions for bigger mortgages.

In addition to the retirement income exclusion being more generous than what almost all other states provide, the full credit is available to anyone receiving retirement income—even very wealthy people. At the current rate

of \$31,110, a married household where both partners receive the full exclusion and the average amount of Social Security income (untaxed in Kentucky) would have \$90,000 in untaxed annual income.<sup>227</sup>

## SALES TAX

The sales and use tax is Kentucky's second-largest source of revenue. At \$3.9 billion in FY 2019, it comprised 34% of total General Fund revenue. Although it remains the second-largest source of revenue, it was responsible for 59% of the nominal growth in General Fund in FY 2019 due to a significant base expansion in 2018 to include many previously untaxed services, and a U.S. Supreme Court Case that permitted states to require out-of-state retailers to collect and remit the sales tax.<sup>228</sup> The sales tax was expanded to a broad range of participatory admissions, installation labor, extended warranty services, landscaping services, small animal veterinary and other services. Admissions to charity events, and items sold by charities at those events, were initially subject to the tax, but the General Assembly exempted all such admissions and sales in subsequent legislation passed in 2019.<sup>229</sup>

Sales tax revenues are expected to grow by 6.5% to \$4.2 billion in 2020, thanks to 2019 legislation extending application of the tax to internet platform providers and continued enhanced compliance with the 2018 base expansions. After 2020, revenue growth from the sales tax is predicted to be tepid. The CFG estimates the sales tax will grow by 1.1% to \$4.2 billion in 2021, and by 2.3% to \$4.3 billion in 2022.

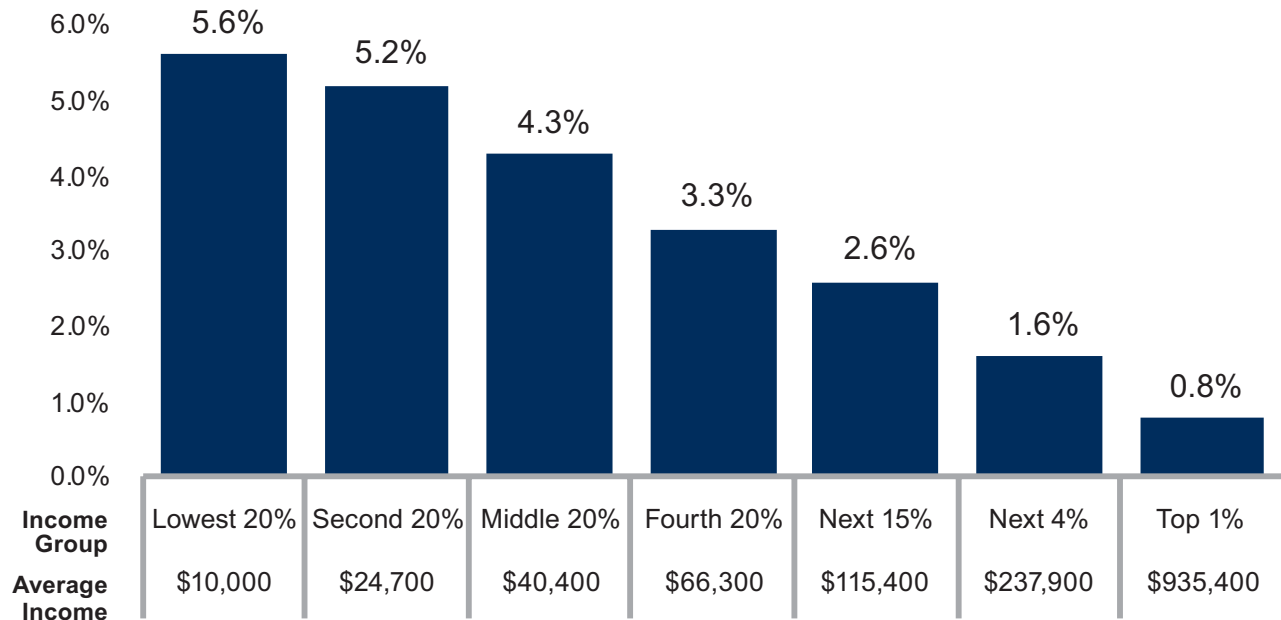
Between 2010 and 2018, sales tax revenue grew 29%—significantly less than the IIT during the same period. Because of structural changes in 2018, sales tax revenues grew by 9.2% in 2019, with nominal growth of \$332 million, which was \$30 million over the estimate.

One explanation for the sales tax's weak performance relative to the income tax is the growing income disparity among Kentucky's residents. Households at the top of the income scale have received a greater share of the economic gains from the recovery, and higher-income households are more likely to save rather than spend additional income.<sup>230</sup> As discussed previously, those who are less well-off and spend all or most of their income on necessities have experienced stagnant or declining wages.

Kentucky excludes food items, prescription drugs and devices, and residential utilities from the sales tax base. Although these exclusions are large, they help to make the sales tax somewhat less regressive. The share of family income that Kentucky families in the bottom 20% of the income distribution pay in sales and excise taxes is 5.6%, while the top 1% pay just 0.8%.<sup>231</sup>

## Sales Tax Asks the Most of People With Least Ability to Pay

Sales tax as a share of family income



Source: ITEP.

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## CORPORATE TAXES

Kentucky imposes two income-type taxes on corporations—the corporate income tax (CIT) and the limited liability entity tax (LLET).<sup>232</sup> The taxes work together, with amounts paid under the LLET credited against the corporate income tax. For this reason, these two taxes are discussed together.<sup>233</sup>

Kentucky's CIT and LLET generated \$763 million in 2019, comprising 6% of the General Fund. In 2020, corporate income tax receipts are forecast to fall by 16.5% to \$637 million. The CFG projects revenues to fall by 5.6% in 2021 followed by 12.7% growth in 2022. Because the growth in 2022 is off of a significantly smaller base, projected revenues in 2022 are estimated to be \$85 million less than in FY 2019. The relatively large increase projected for 2022 is due to banks moving from payment of the bank franchise tax to payment of the CIT, a move that is expected to result in an overall loss of revenues to the General Fund of \$56 million beginning in 2022.

Corporations and pass through entities are among the biggest beneficiaries of the 2018 and 2019 tax changes. Tax cuts for corporations include the following:

- The progressive CIT rate structure with a top rate of 6% was repealed and replaced with a flat rate of 5%.
- For multi-state corporations, Kentucky went from using property, payroll and double-weighted sales as factors for determining apportionment of income to Kentucky to using just sales, which reduces taxes for corporations with more property and payroll in Kentucky.<sup>234</sup>
- A tax credit was enacted against the CIT for property taxes paid on inventory, phasing in over 4 years—25% in 2018, 50% in 2019, 75% in 2022, and 100% for 2021 and thereafter.

- An increase was made from \$25,000 to \$100,000 for expense deductions under Section 179 of the Internal Revenue Code.<sup>235</sup>

The one bright spot among the myriad of corporate tax changes was a new requirement in 2018 that related companies file in Kentucky using unitary combined reporting beginning in 2019. Unitary filing is recognized as the method that provides the least opportunity for corporations to shelter income and avoid state corporate income taxes. However, the potential positive impact of this change was watered down by other provisions that allow related corporations to elect to file using the same group used under federal law, rather than the unitary combined method, and allow corporations to share net operating losses among members.

The significant changes to corporate taxes in 2018 and 2019 will make estimating corporate revenues particularly difficult going forward—and corporate taxes were already notoriously volatile and therefore difficult to predict prior to the recent amendments. This is true in large part because of differing state tax codes, which provide multi-state corporations with a multitude of tax avoidance opportunities that may shift from year to year resulting in large swings in individual states.

The largest exemption from the LLET is the small business exclusion that allows all businesses with less than \$3 million in gross profits or receipts to pay a minimum tax of \$175. Businesses with gross receipts or profits between \$3 and \$6 million receive a partial credit that phases out as gross receipts or profits approach \$6 million. This credit is very generous and results in substantial revenue losses of \$17 million annually.

## COAL SEVERANCE TAX

Since 2012, when coal severance tax receipts were at a high, receipts have fallen by 69%, from \$298 million to \$92 million. And in 2019, \$15 million of the amounts received were one-time monies from the settlement of outstanding tax cases, and not current year receipts. The decline is the result of a variety of factors including low natural gas prices, reduced demand for coal and environmental regulations for coal-fired power plants.

The revenue forecast for the biennium anticipates further decline. The coal severance tax is expected to drop by 40% in 2020, 18% in 2021 and another 20% in 2022 to a new low of \$37 million in 2022—just 19% of 2012 receipts.

In addition to the impact on the state General Fund, the dramatic and continuing reduction in coal severance tax receipts has significantly diminished local government revenues in coal producing counties. Historically, these local governments received up to half of the coal severance tax revenues, with increased amounts going back to local governments over the last two biennia. The loss of these funds, coupled with a change in the way unmined minerals are assessed, has left some local governments reeling and with few good options to raise other revenues.<sup>236</sup>

## PROPERTY TAX

Property taxes grew by 4.1% in 2019 to \$647 million. The forecast assumes 1.6% growth in 2020, 2.2% in 2021 and 3.5% to \$695 million in 2022.

Real property (land and buildings) constitutes the largest component of the overall property tax base.<sup>237</sup> Because the statutes require the real property tax rate to be adjusted annually to produce no more than 4% revenue growth over the previous year, total property tax revenue is relatively stable but also suppressed. Though housing

prices have begun to recover since the crisis, they have not grown enough to trigger a reduction in the rate since 2008. As previously described, between 1979 and 2008 the rate fell from 31.5 cents to 12.2 cents per \$100 in assessed value. If assessment growth does not trigger a rate reduction between now and then, the cap will cost the commonwealth \$569 million in 2020.

## CIGARETTE TAX

The cigarette tax rate was increased in 2018 from 60 cents per pack to \$1.10 per pack. The increased rate ranks Kentucky 36th overall, and is still 70 cents below the national average of \$1.81.<sup>238</sup> The state could raise temporary needed new revenue and create health-related savings by further increasing the tax rate. Because raising the cigarette tax also reduces consumption, it cannot be relied upon to provide a growing stream of revenue over the long term.

Combined with other anti-smoking efforts and changing attitudes, cigarette consumption and therefore revenues from the tax are on a long-term downward trend. The 2018 rate increase was estimated to generate an additional \$129 million in revenues in FY19, and total revenues grew to \$353 million. Beginning in FY20, the CFG estimates that the receipts will once again begin to decline, projecting \$345 million in FY20, \$337 million in 2021, and \$330 million in 2022.

## LOTTERY REVENUE

At \$264 million, lottery dividends made up 2.3% of the General Fund in 2019. These revenues exceeded the official estimate by \$14.9 million and were 4.5% more than lottery revenues in 2018. The forecast predicts growth of 2.7% in 2020, and 2.2% in both 2021 and 2022. Revenue from Kentucky's lottery is primarily (and statutorily) devoted to providing college scholarships and supporting other education-related initiatives, but in the past, lottery funds have been diverted to help balance the budget.

## OTHER REVENUE

The "other revenue" category combines several smaller miscellaneous revenue sources, including the insurance premium tax, bank franchise tax, telecommunications tax, abandoned property sales and "payment in lieu of taxes" (PILOT) receipts.

The other revenues category had an unusually good year in 2019, bringing in \$790 million and exceeding the estimate by \$73 million, which constituted 37% of the \$194 million General Fund surplus. The primary contributors to the increase in revenues include one-time receipts of \$35 million from the sale of abandoned securities, \$21 million from the cigarette floor stocks tax, and receipts over the estimates from the bank franchise tax of \$16.5 million and insurance tax of \$15.2 million.

These sources accounted for 6% of the General Fund in 2019. Because of the unusual level of receipts in this category in 2019, revenues are expected to decrease by 5.9% in 2020 and to increase by 1.3% in 2021. In 2022, they are expected to significantly decrease by 14.9% due to the repeal of the bank franchise tax. Beginning in 2022, banks will begin paying the corporate income tax rather than the bank franchise tax.

Inheritance taxes, also classified as "other" tax revenue, contributed \$48 million to the General Fund in 2019. These revenue are reduced by exemptions and special exclusions from the inheritance tax, which are expected

to be \$45 million in the current year and \$44 million in each year of the upcoming biennium. Since federal tax changes in the early 2000s eliminated Kentucky's estate tax, taxes on inherited wealth in Kentucky have dropped 46%.

## TOBACCO SETTLEMENT FUNDS

As a result of the Master Settlement Agreement (MSA) between tobacco companies and states in 1998, companies make annual payments to states for costs associated with treating tobacco-related illness. While not a source of General Fund revenue, these payments fund priorities in the budget: half to agricultural development and half to early childhood development and health care improvement programs. Kentucky has received a total of \$2.2 billion in payments since 1998.

MSA payments in 2019 were \$118 million, \$2 million below the estimate. Receipts declined by 4% in FY19 and are expected to continue declining with \$111 million in projected revenue for 2020 (\$7 million below the estimate used for the 2018–2020 budget), \$106 million in 2021, and \$103 million in 2022. The average annual payment over the first 10 years from 2004 to 2013 was \$107 million. While a recent settlement regarding tobacco companies not participating in the MSA boosted payments in the short term and smooths out future payments, declining consumption means tobacco settlement monies will continue to be a shrinking share of Kentucky's total revenue over time.

## FEDERAL REVENUE

The primary purpose of this portion of the report is to provide detailed information about state revenues and resources, however it is important to note that federal funds comprise the largest portion of revenues appropriated each year in our budget. The federal government disperses grant funds and other forms of assistance to states for a variety of purposes such as Medicaid, Title 1 funds for poor schools, the National School Lunch Program, Temporary Assistance to Needy Families (TANF), Head Start and highway construction and infrastructure. While some funding is based on a formula or the number of eligible recipients in Kentucky, other funds are provided based on direct appropriations for specific projects or according to other means as determined by Congress. The General Assembly has very little control over the amounts received or how the funds can be spent.

## PART III: ROAD FUND

### NEEDED ROAD FUND INVESTMENTS SUBSTANTIAL

Like the General Fund, resources available in the Road Fund to address identified transportation infrastructure needs are inadequate.

Starting with the 2018–2020 biennium, the Transportation Cabinet implemented a planning process it calls the “Strategic Highway Investment Formula for Tomorrow” (SHIFT) to establish a data-driven approach to identifying and prioritizing transportation projects so that the six-year transportation plan is more realistic and not grossly over-programmed as it has been in the past.<sup>239</sup> The cabinet will continue to use SHIFT in developing and planning transportation projects going forward.

During the current biennium, the Transportation Cabinet received additional funding to begin the process of repairing or rehabilitating over 1,000 bridges identified as having critical needs.<sup>240</sup> Funds devoted to repairing and replacing bridges were increased from \$122 million to \$179 million annually, with a goal of improving or replacing over 400 bridges during the current biennium. The remaining backlog of over 600 bridges will need additional funding going forward.<sup>241</sup>

The state maintains over 27,500 miles of road in Kentucky, and the current state highway plan has identified over \$1 billion in maintenance backlogs—representing over 3,700 miles of road. Without significant additional funding, the backlog is expected to grow to over 6,000 miles of roadway over the next 6 years, despite an increase in funding for these types of projects from \$175 million to \$325 million annually during the 2018–2020 biennium.

The new planning process has improved the method for identifying and prioritizing projects, ensuring that the most critical projects move forward first. However, the loss of \$120 million in federal toll credits after 2020, flat revenue growth and the continued diversion of Road Fund resources to other parts of state government will undermine continued progress in addressing Kentucky’s huge backlog of over \$6 billion in unfunded priorities plus an additional \$1.8 billion in projects added by the General Assembly during the 2018–2020 legislative session. The Transportation Cabinet estimates that an additional \$490 million in Road Fund revenues are needed annually to address the entire list of priority projects. In addition to projects already included in the plan, the Brent Spence bridge project in Northern Kentucky and the Ohio River bridge project in Henderson County are currently not included in the plan, and will require over \$680 million in funding over the next 6 years.<sup>242</sup>

### INSUFFICIENT ROAD FUND REVENUE

The Road Fund is the primary source of state funds for road construction and maintenance in Kentucky. Kentucky’s Constitution requires that any license or excise tax or fee relating to gasoline and other motor fuels or to the registration, operation or use of vehicles on public highways be spent on our highways.<sup>243</sup>

The 2018–2020 budget assumed small growth over the biennium, with \$2 million more in 2019 and \$3.2 million more in 2020. Road Fund revenues in FY18 came in \$7.7 million over the estimate, and were significantly better than expected in 2019 with \$60 million more than the estimate of \$1.6 billion.<sup>244</sup> The road fund surplus in FY19 was \$75 million with the extra resources coming primarily from the extra tax collections and spending lapses.

Pursuant to the surplus expenditure plan for the Road Fund, the extra revenues were transferred to the State Construction Account for use in highway construction.

However, the Road Fund is still feeling the effects of a steep drop in receipts between FY14 and FY16 due largely to a reduction in the motor fuels tax rate, which remains the largest source of Road Fund revenue, constituting 49% of all revenues received in 2019.

The gas tax rate, which is currently 26 cents per gallon for gasoline and 23 cents per gallon for diesel, has several components:

- A variable rate that adjusts annually based on 9% of the average wholesale price of gasoline (currently 19.6 cents) subject to a floor and limitations on total increases and decreases,
- A supplemental highway user's fee of five cents for gasoline and three cents for diesel, and
- An underground storage tank fee of 1.4 cents.<sup>245</sup>

A big factor in the inadequacy of Road Fund receipts over the last biennium was a drop of 6.5 cents per gallon in the motor fuels tax rate in 2015, with each penny reduction equaling approximately \$32 million in lost Road Fund revenues.<sup>246</sup> In order to safeguard current revenues and prevent further precipitous drops, in the 2015 General Assembly increased the "floor" (a minimum rate that will be imposed regardless of the wholesale price) and established a new smoothing process for future rate changes.<sup>247</sup> Though stabilized, revenues are not expected to grow robustly in the future as cars become more fuel-efficient and fuel prices remain relatively low. Many other states are experiencing the same problems as Kentucky, with several raising their taxes over the past two years to address significant unmet needs.<sup>248</sup>

The Motor Vehicle Usage Tax, imposed at a rate of 6% on the purchase price of motor vehicles, is the second-largest source of revenue for the Road Fund, comprising 33% of all receipts in 2019. Receipts were slightly below the estimate for 2018 coming in \$6.7 million or 1.3% short. Receipts rebounded slightly in 2019, coming in \$21 million or 4.2% over the estimate.

The CFG estimates assume receipts of \$1.6 billion in FY20, \$56 million over the original estimate prepared in 2018. Tepid growth is once again projected for the next biennium, with just \$0.6 million in new revenues for FY21, and \$19.7 million in FY22.

Other factors impacting the Road Fund in the coming biennium include:

- In FY20, \$112 million in Road Fund revenues have been allocated to other areas of state government, the largest of which is approximately \$107 million to Kentucky State Police. Over the biennium, \$223 million, or 7.2% of total Road Fund receipts, was diverted from the Road Fund from other areas of state government, a 66% increase since the 2006–08 budget.<sup>249</sup> These fund shifts started during a period when Road Fund receipts were strong and General Fund receipts were lagging, and will likely continue in the next biennium, despite the lack of growth in the Road Fund.
- As mentioned previously, in 2020 a federal toll credit program that has provided the state match for federally funded projects will expire. This means Kentucky will have replace approximately \$120 million in revenues from these lost resources in the future to maintain the same level of funding.<sup>250</sup>

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- <sup>233</sup> Because these taxes are interrelated, the Consensus Forecasting Group (CFG) started forecasting them together beginning with the August 2017 planning estimates.
- <sup>234</sup> The three factor formula was retained for some specific types of corporations that pay less in taxes by using it.

- <sup>235</sup> Additionally, these changes included an expansion of the recycling tax credit, a new farmer small business tax credit, and an obscure provision that allows “deferred tax relief” to large multi-state corporations to offset “paper” increased tax expenses that must be reported by some corporations on their financial statements. OSBD testified at the August meeting of the CFG that 125 corporations applied for the deferred deduction, claiming \$444 million in deferred expenses, which means beginning in 2024, those corporations could be eligible to claim up to \$44.4 million in additional deductions each year for 10 years. The dubious nature of this tax break is thoroughly described in the following: Michael Mazerov, “States Should Reject Corporate Demands for ‘Deferred Tax’ Deductions,” Center on Budget and Policy Priorities, May 23, 2019, <https://www.cbpp.org/sites/default/files/atoms/files/5-13-19sfp.pdf>.
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- <sup>246</sup> In addition to hurting the state’s Road Fund in FY15, the drop has negatively impacted local governments who receive approximately 48% of gas tax collections through revenue sharing programs to support local streets and roads.
- <sup>247</sup> The motor fuels tax rate fluctuates based on the average wholesale price of gasoline. In 2015, with gas prices low, the tax rate, which was at 31.9 cents per gallon, fell by 4.3 cents on January 1 and was scheduled to fall another 5.1 cents on April 1. The General Assembly enacted legislation establishing a floor of 26 cents per gallon, which is where the rate remains today.
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